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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 1085

WATERMAN STEAMSHIP CORPORATION,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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INDEX

	Page
Opinions Below	1
Jurisdiction	2
Question Presented	2
Statutes and Regulations Involved	2
Statement of the Case	2
Reasons for Granting the Writ	10
1. The Decision Below Determines Erroneously An Important Question Of Federal Law Which Should Be Settled By This Court	9
2. The Decision Below Is In Conflict With The Decisions Of This Court On What Constitutes A Dividend	14
3. The Decision Below Conflicts With The Applicable Decisions Of This Court, The Decisions Of Other Courts Of Appeal And Rule 52(a) Concerning The Scope Of Appellate Review	16
Conclusion	20
Appendices	A-1

CITATIONS

Cases (Pending and Decided):	
American Mfg. Co. v. U.S., U.S.D.C., E.D.N.Y. (C. A. No. 68C1096)	10
Bazley v. Commissioner, 331 U.S. 737 (1947)	15
Commissioner v. Court Holding Co., 324 U.S. 331 (1945)	16, 17, 18
Commissioner v. Duberstein, 363 U.S. 278 (1960)	16

CITATIONS (Continued)

	Page
Commissioner v. Gordon, 391 U.S. 83 (1968)	9, 14
Doerschuck v. U.S., 274 F. 739 (E.D.N.Y. 1921)	15
Fisher v. Marumber, 252 U.S. 189 (1920)	16
Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695 (4 Cir. 1963)	16
Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2 Cir. 1956)	15
King Enterprises, Inc. v. U.S., 418 F.2d 511 (Ct. Cl. 1969)	11
Motor Finance Co., U.S.D.C., N.J. (C.A. 748 67)	10
National Industries, Inc., Tax Court Docket No. 3690-69	10
Lauren Charles of the Ritz, Inc., Tax Court Docket No. 5950-70	10
Road Materials, Inc. v. Commissioner, 407 F.2d 1121 (4 Cir. 1969)	16
United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950)	16, 17, 18, 19
U.S. v. Phellis, 257 U.S. 156 (1920)	16
Statute:	
Internal Revenue Code of 1954 (26 U.S.C. 1964 ed.):	
Sec. 243	10, 11, A-63
Sec. 246	14, A-64
Sec. 312	2, 15, A-64

CITATIONS (Continued)

	Page
Sec. 316	2, A-55
Sec. 317	2, A-56
Sec. 1501	2, A-56
Sec. 1502	2, A-57

Miscellaneous:

Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966) 11

Cohen, Surrey, Traleau, & Warren, "A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders", 52 Col. L. Rev. 1 (1952) 11

H. Rept. No. 708, 72d Cong., 1st Sess., 12 (1932) 11

OD 471, 2 Cum. Bull. 26 (June 1920) 15

Revenue Ruling 57-201, 1957-1 Cum. Bull. 295 14

Sen. Rept. No. 830, 88th Cong., 2d Sess., 74 (1964) 12

Sen. Rept. No. 960, 70th Cong., 1st Sess., 13-15 (1927) 12, A-62

Treasury Regulations on Income Tax (26 C.F.R.):

Sec. 1.301-1(d) 15, A-68

Sec. 1.301-1(h) 15, A-68

Sec. 1.1502-31A 2, 7, 12, A-69

Sec. 1.1502-32 12, 13

Sec. 1.1502-36A 14, A-71

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No

WATERMAN STEAMSHIP CORPORATION,
Petitioner,
versus.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Waterman Steamship Corporation, Petitioner, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in this proceeding on July 15, 1970.

OPINIONS BELOW

The opinion of the Court of Appeals for the Fifth Circuit (A-2),[1] reported in 430 F.2d 1185 (5th Cir. 1970), the order of that Court denying Petitioner's petition for rehearing (A-1), and the opinion of the Tax Court

[1]All references herein designated "A" are to pages in the Appendices hereto and all designated "R" are to the certified Record.

(A-30), reported in 30 T. C. 630 (1968), appear in the Appendix hereto.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was entered on July 15, 1970. A timely petition for rehearing was denied by order of that Court dated September 17, 1970, and this petition for certiorari was filed within ninety (90) days of that date. Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether the distribution received by Petitioner from its wholly-owned subsidiary, Pan-Atlantic Steamship Corporation, was a tax free, intercompany dividend or was part of the purchase price paid to Petitioner in a sale of the stock of such subsidiary. The Tax Court held the distribution was a dividend. The Court of Appeals reversed.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 312, 316, 317, 1501, and 1502 of the Internal Revenue Code of 1954 and Section 1.1502-31A of the Regulations thereunder are set forth in Appendix D, *infra*, A-62.

STATEMENT OF THE CASE

Since the detailed facts appear in both the opinion of the Tax Court and the Fifth Circuit (appended here-

fact, only a factual summary of the facts will be made here.

On December 20, 1954, Malcom P. McLean (Mr. McLean) submitted to Pettaquamscutt, Waterman Steamship Corporation (Waterman), a written offer to purchase all of the outstanding stock of its two wholly owned subsidiary corporations, Pan Atlantic Steamship Corporation (Pan Atlantic) and Gulf Florida Terminal Company (Gulf Florida), for $3,500,000. Waterman was at that time a publicly held corporation.

On December 21 the Waterman Board met to consider Mr. McLean's offer. After reading the offer, Waterman's president pointed out that a dividend in excess of $2,500,000 had been under consideration for some time and that, because of the adverse tax consequences which would result should the stock be sold prior to the payment of such dividend, he would strongly oppose any sale prior to the payment of such dividend.* (A-34) On the president's recommendation the Waterman Board rejected Mr. McLean's offer, and author-

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*Waterman's cost basis in the stock of the two subsidiaries was $700,180.00, and a sale of stock, without the payment of such dividend, would have resulted in a gain of $2,800,000.00 and a capital gain tax of approximately $700,000.00. However, since Waterman had allowed its two subsidiaries to accumulate and reinvest their earnings in assets, a sale of the assets of the subsidiaries for $3,500,000.00 (by the subsidiaries or by Waterman following liquidation of its subsidiaries) would have resulted in a loss of $892,545.00 (net adjusted basis less $3,500,000.00), which could have been availed of on the consolidated income tax return of the Waterman group. (A-43)

McLean was not interested in a purchase of assets as such would require I. C. C. approval. (A-34; A-49; R. 51)

ized the president to submit a counter proposal (A 35, R 29) Thereupon, Waterman's president wrote Mr McLean rejecting his offer, and making a counter proposal to sell the stock to Mr McLean or his nominee for $7,000,000 "after the Directors [of the two subsidiaries] ... shall have declared and arranged for the payment of dividends to the present stockholder, Waterman Steamship Corporation, amounting in the aggregate to $2,000,000"* (A 36, R 30) Additional conditions were that documentary proof would be submitted that Interstate Commerce Commission (I C C) approval of the sale would not be necessary and that there would be no change in the financial condition of the subsidiaries, except for such as might result from ordinary operations and from the payment of such dividends (A 36, R 30) The counter proposal was never accepted (R 55)

It is undisputed that Mr McLean was in control of McLean Trucking Company (Trucking) and as both Trucking and Pan Atlantic were certificated carriers it was necessary for Mr McLean to formulate a method of divesting himself of control of Trucking before he could acquire control of Pan Atlantic without I C C approval Between the time the counter proposal was made and January 21, 1955 Mr McLean and his coun-

*In its opinion the Court of Appeals places great emphasis on its conclusion that "the Tax Court believed no dividend would have been paid but for the contemplated sale." (A-27) The Tax Court opinion contains no statement from which the Court of Appeals could have inferred such a belief. On the contrary, the findings of fact clearly establish that the payment of a substantial dividend had been under consideration for some time. (A-34)

and worked diligently on formulating a method to eliminate his control of Truckeng and in drafting the documents and obtaining the participations by other parties that would be required to consummate the sale without I.C.C. approval. The method that was formulated involved the organization of a new corporation, McLean Securities Corporation (Securities) by Truckeng, the distribution of the stock of Securities to the stockholders of Truckeng, and the placing of Mr. McLean's Truckeng stock in trust with a large, established independent trustee. (A-38; A-39; R-67-71.)

On January 21, 1955 the following occurred in the following order: (A-10; A-12; A-39; A-42.)

a. Waterman's counsel and Mr. McLean's counsel met for the first time to consider the stock purchase agreement as drafted by Waterman's counsel and the method to be employed by Mr. McLean to eliminate his control of Truckeng.

b. The Board of Pan Atlantic declared dividends on both its preferred and common stock to Waterman in the form of a promissory note in the amount of $2,799,820 payable on or before February 20, 1955, and bearing interest at 4%.*

c. The Board of Securities authorized the purchase and financing of the stock of Pan-Atlantic and Gulf Florida.

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*The question of whether a note, as a matter of law, may be issued in payment of a dividend was not litigated in either the Tax Court or the Court of Appeals. (A-3; A-45)

d. The Board of Waterman, after noting receipt of the promissory note distributed by Pan-Atlantic as a dividend, authorized the sale of the stock to Securities. Immediately following this meeting Waterman's president informed Mr. McLean that the Waterman Board had approved the proposed sale and Mr. McLean then executed the trust agreement divesting himself of control of Trucking. (A-12) The closing agreement for the sale of the stock was then executed.

e. A new Board of Pan-Atlantic authorized the corporation to borrow $2,500,000 from Mr. McLean and $299,820 from Securities and to deliver Pan-Atlantic's notes therefor (due January 21, 1960, with interest at 6%); and to issue a check to Waterman for $2,799,820 in payment of the note that had been distributed as a dividend. Mr. McLean borrowed from Bethlehem Steel Corporation the $2,500,000 which he lent Pan-Atlantic immediately following Securities' purchase of the Pan-Atlantic and Gulf Florida stock. (A-12; A-42; R.81) The notes which Pan-Atlantic issued Mr. McLean and Securities remained outstanding obligations of Pan-Atlantic until late 1958. (A-13; A-43)

Thus, Waterman held Pan-Atlantic's note for $2,799,820 prior to the sale, and, after the sale, Mr. McLean and Securities held Pan-Atlantic's notes for $2,500,000 and $299,820, respectively.

It was stipulated that Pan-Atlantic had earnings and profits of at least $2,799,820 prior to the distribution of the $2,799,820 note to Pan-Atlantic. As noted in footnote 2 on page 3, a sale of the assets of the subsidiaries

for $3,500,000 would have resulted in a loss of $692,545; however, McLean was not interested in an acquisition of assets as such could not have been effected without I.C.C. approval.

Waterman and its subsidiaries filed consolidated income tax returns. On the tax return filed for the period in question Waterman, acting pursuant to Reg. § 1.1502-31A(b)(1)(i), eliminated from its income as an "intercompany transaction" the $2,799,820 dividend distribution it received from Pan-Atlantic and reported the sale price of the stock of Pan-Atlantic and Gulf Florida at $700,180. The Commissioner assessed a deficiency, asserting that Waterman received a capital gain of $2,799,533 from the sale of such stock.

Although the Tax Court stated that "*Some* of the facts have been stipulated and are found accordingly" (A-30), the Court of Appeals below treated the case as one which had been tried *solely* upon a stipulation of facts and, under the pretense of "[inquiring] into the correct application of the tax law to the undisputed facts," proceeded to review the facts and case de novo. (A-18) The case was actually tried upon the oral testimony of Mr. McLean and his attorney, Mr. Higginson, as well as the stipulation. They were the sole representatives of Securities throughout the transaction and as their oral testimony was directed to the *substance* of the events in question it should not have been but was ignored in determining the question of whether the distribution was a dividend. The examination and cross examination of these witnesses appears in the certified record at pages 45 through 94.

The real issue considered and decided by the Tax Court was that of whether a dividend had in fact been declared by Pan-Atlantic. (A-46) The Commissioner did not argue that a dividend could not be paid by a note, but rather that the declaration of the dividend and distribution of the note was a subterfuge. (A-47; A-45)

Looking at events subsequent to January 21, 1955,* four dissenting judges of the Tax Court said that Pan-Atlantic was "no richer and no poorer" when the transaction was completed as it had neither declared nor paid a dividend to Waterman or anyone else (A-13; A-60). This is not true. Pan-Atlantic was poorer by $2,799,820 from the moment the dividend was declared. It first gave Waterman a note for the amount of the dividend and then gave Mr. McLean and Securities notes for the amounts borrowed from them to pay the dividend note.

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*At the insistence of underwriters, Mr. McLean transferred Pan-Atlantic's note to Securities on July 5, 1955 in exchange for preferred stock of Securities. More than three years later, Securities contributed the $2,500,000 to Pan-Atlantic by marking the note paid. Later Pan-Atlantic paid the $299,820 note. (A-13; A-43) These subsequent transfers were unrelated to and made independent of the acquisition of Pan-Atlantic. The transfer to Securities was occasioned by the fact that Securities was undergoing a subsequent underwriting of preferred stock. Rather, the fact that these 6-year notes were outstanding for over 3 1/2 years demonstrates that a bona fide indebtedness was intended and existed.

REASONS FOR GRANTING THE WRIT

1. The Decision Below Determines Erroneously An Important Question Of Federal Tax Law Which Should Be Settled By This Court.

A resolution by this Court of the circumstances under which there may be a presale extraction of a subsidiary's earnings and profits, without adverse tax consequences, is of the utmost importance in the just administration of the federal tax laws. Sales and acquisitions of corporate subsidiaries occur daily, and sales of stock, as compared with sales of assets (whether by the subsidiary or by the parent following liquidation), may produce widely disparate results where the parent corporation has allowed its subsidiary to accumulate and reinvest its earnings in operating assets. Where a sale of assets is not possible for non-tax reasons, the parent corporation should be allowed, without adverse tax consequences, to refuse to sell the stock until the accumulated earnings and profits have been removed by way of a dividend (as Waterman did), and, where the retained earnings have been reinvested, the subsidiary should be permitted to borrow the funds with which to pay such dividend. The substance of the transaction is the same whether the subsidiary distributes its own cash or assets or borrows the funds with which to pay the dividend — in either event the net worth of the subsidiary is reduced by the exact amount of the dividend distribution. Compare *Commissioner v. Gordon*, 391 U.S. 83, 88 S.Ct. 1517, 20 L.Ed.2d 488 (1968).

Petitioner is informed of at least three pending cases involving a presale extraction of accumulated earnings where the purchaser has become involved, by guaranty or actual loan, in the loan obtained by a subsidiary to pay the dividend in question: *National Industries, Inc.*, Tax Court Docket No. 3690-69; *Lanvin-Charles of the Ritz, Inc.*, Tax Court Docket No. 5950-70; *American Mfg. Co. v. U. S.*, U.S.D.C., E.D.N.Y. (C.A. No. 68C1096). While these cases involve the § 243 dividends received deduction generally available to all corporations even though not filing consolidated returns (85%, and in some cases 100%), the issue is the same: Whether the substance of the transaction is changed by the fact that the purchaser is or becomes involved in the loan obtained to pay the dividend. In a fourth case now pending, *Motor Finance Corp. v. U. S.*, U.S.D.C., N.J. (C.A. 748-67), the dividend was paid by the subsidiary corporation out of its own funds prior to the sale of the stock.

The decision of the Court of Appeals below has added even more confusion to an already troubled area of the tax law, and until this Court speaks on the subject it will be impossible for taxpayers, such as Waterman and Securities, to determine with reasonable expectancy what will be the tax consequences of their transactions. In adding its footnote on page A-29, the Court of Appeals clearly recognized that its decision would cause great confusion as to the tax consequences of a presale extraction of earnings and profits. If anything, the footnote adds further to the confusion. The Court of Appeals having attacked a presale extraction of earnings and profits as a new horizon of tax avoidance, it is more likely that businessmen will

shudder when they think of the Court of Appeals' assurance that "its decision should not be interpreted as standing for the proposition that a corporation which is *contemplating* a sale of its subsidiaries' stock *could not under any circumstances* distribute its subsidiaries' profits prior to the sale without having such a distribution deemed part of the purchase price." (A-29)

It is clear that the Court of Appeals was preoccupied with what it thought to be the tax avoidance implications of the transaction in question. (A-27; A-28) If the Court of Appeals had looked beyond "substance versus form" maxims to the applicable legislative history, statutes and regulations, it would have realized that it was not faced with a case involving income tax circumvention. The legislative history of §243(a)(1) and its predecessor discloses a Congressional policy against the multiple taxation of corporate earnings as they pass from one corporation to another by permitting a dividends received deduction to corporations on the "theory that a corporate tax has already been paid upon the earnings out of which the dividends are distributed". H.Rept.No. 708, 72d Cong., 1st Sess., 12 (1932); Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, (2d edition 1966) 57; *King Enterprises, Inc. v. U. S.*, 418 F.2d 511 (Ct. Cl. 1969). This preferential treatment "is based on the premise that a single corporate tax on corporate earnings suffices until those earnings are obtained by individual stockholders." Cohen, Surrey, Tarleau, and Warren, "A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders", 52 Col.L.Rev. 1, 49 (1952).

This legislative purpose was reaffirmed by Congress in 1964 when it increased the dividends received deduction from 85% to 100% for affiliated corporations not filing consolidated returns. S.Rept.No. 830, 88th Cong., 2d Sess., 74 (1964).

In the case of corporations filing consolidated returns, the Treasury implemented such Congressional policy by adopting Reg. § 1.1502-31A (b)(1) which eliminates from the computation of taxable income "dividend distributions from one member of the group to another member of the group". These regulations also provide that "In the computation of the dividends received, there shall be excluded all dividends received from other members of the affiliated group." Reg. § 1.1502-31A(b)(2)(ii)

It is apparent from the foregoing that the Congressional purpose in providing for the filing of consolidated returns was to recognize and tax the consolidated group as a single business entity, to disregard for tax purposes the separate corporate entities of the corporations comprising the consolidated group and to permit the transfer of earnings and profits of a subsidiary to its parent without adverse tax consequences. S.Rep. 960, 70th Cong., 1st Sess., 13-15 (1927) (A-62).*

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*The consolidated return regulations have been revised to reflect the fact that there is no circumvention of capital gains taxes where a parent corporation allows its subsidiary to accumulate and reinvest its earnings. Under Reg. § 1.1502-32, applicable to years beginning after December 31, 1965, the basis of stock in a subsidiary is increased by the amount of its earnings and decreased by the amount of its dividends. In order to place a parent corporation in the same position as though the subsidiary's earnings and profits in preaffiliation years and years governed by the old regulations had been earned in post-1965 consolidated return years, these regulations provide for a

In the instant case Pan-Atlantic did nothing more than transfer its previously taxed earnings and profits to its parent.

The Waterman group was unable to recognize its actual loss of $692,545 on the transaction because a sale of assets was not possible for non-tax reasons (i.e., I. C. C. approval would have been required.); it therefore sought to avoid recognition of what would have been an "artificial gain" by having Pan-Atlantic declare a dividend of its previously taxed earnings and profits. There was no circumvention of capital gains taxes as the $2,300,000 in question did not represent appreciation in the value of assets or stock over a period of time, but merely reflected the fact that Waterman had allowed a member of its affiliated group to accumulate and reinvest its earnings in assets. This is clearly demonstrated by the fact that the cost basis of the subsidiaries' assets exceeded by $692,545 the amount which Securities obviously thought to be their fair market value. Here both the means employed and the substantive result were clearly within the Congressional purpose in providing preferential treatment for intercorporate distributions and for the filing of consolidated returns.

"Deemed Dividend" under which it is assumed that the entire accumulated earnings and profits of the subsidiary were distributed to the parent and immediately contributed back to the capital of the subsidiary, thus increasing the parent's basis in the stock of the subsidiary. Reg. § 1.1502-32(f) (2).

This change does not diminish the significance of the decision of the Court of Appeals below since that decision is equally applicable to corporations not filing consolidated returns.

Capital gains treatment is not circumvented, and there is no tax avoidance, where the distribution is of earnings and profits — a view subscribed to by the Treasury in Revenue Ruling 57-201, 1957-1 Cum. Bull. 295. Further potential circumvention described by the Court of Appeals in its opinion (A-27) — the claim of a loss following a dividend — is specifically covered and avoided by Regulation §1.1502-36A(a)(2) for corporations filing consolidated returns and by § 246(a)(1) of the Code for corporations not filing consolidated returns.

Thus, it clearly appears that the Court of Appeals' erroneous determination of this important issue was based primarily upon a misconception of the applicable law. It is therefore essential to the preservation of the strong Congressional policy of long standing involved in this case that the decision of the Court of Appeals be reviewed by this Court and reversed.

2. The Decision Below Is In Conflict With The Decisions Of This Court On What Constitutes A Dividend.

In determining that Pan-Atlantic "neither declared or paid a dividend" and "acted as a mere conduit," the decision of the Court of Appeals below directly conflicts with decisions of this Court concerning what constitutes a "distribution of property" and a "dividend." In *Commissioner v. Gordon*, 391 U.S. 83, 88 S.Ct. 1517, 20 L.Ed.2d. 488 (1968), this Court said:

> "Under §§ 301 and 316 of the Code, subject to specific exceptions and qualifications provided in the Code, *any distribution of prop-*

> *erty by a corporation to its shareholders out of accumulated earnings and profits is a dividend taxable to the shareholders as ordinary income.* Every distribution of corporate property, again except as otherwise specifically provided, 'is made out of earnings and profits to the extent thereof. . . .' (Emphasis added.)
>
> Whether the actual dividend occurs at the moment when valuable rights are distributed or at the moment when their value is realized through sale or exercise, it is clear that when a corporation sells corporate property to stockholders or their assignees at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a 'distribution of property' as that term is used in § 316. Such a sale thus results in a dividend to shareholders unless some specific exception or qualification applies. . . ." 391 U.S. at 88, 89 -- footnotes omitted.

Pan-Atlantic declared a dividend out of its accumulated earnings and profits payable in Pan-Atlantic's note, and since it is unquestioned that a note may be issued in payment of a dividend,[7] the distribution was in fact a dividend.

Pan-Atlantic was truly "poorer" after the transac-

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[7] *Bazley v. Commissioner*, 331 U.S. 737, 91 L.Ed. 1782 (1947); *Kraft Foods v. Commissioner*, 232 F.2d 118, 126 (2 Cir. 1956); *Doerschuck v. U.S.*, 274 F. 739 (E.D.N.Y. 1921); OD 471, 2 Cum. Bull 26 (June 1920); § 312 I.R.C., Reg. § 1.301-1(d), Reg. § 1.301 - 1(h), Appendix D, *infra*.

tion was completed and thus was not a "mere conduit". It is the appropriate function of a dividend to convert a part of accumulated surplus from property of the company into property of the individual stockholders. *U.S. v. Phellis*, 257 U.S. 156, 171, 66 L.Ed. 180 (1921); *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920).

3. The Decision Below Conflicts With The Applicable Decisions Of This Court, The Decisions Of Other Courts Of Appeal And Rule 52(a) Concerning The Scope Of Appellate Review.

It is well established that it is for the trial court, upon consideration of the entire transaction, to determine the facts, the factual inferences to be drawn from the facts and the factual category in which the particular transaction belongs, and its determination is not to be set aside unless clearly erroneous. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981 (1945); *United States v. Cumberland Pub. Serv. Co.*, 388 U.S. 451, 70 S.Ct. 280, 94 L.Ed. 251 (1950); Rule 52(a) Federal Rules of Civil Procedure). The rule applies to factual inferences from undisputed basic facts, *Commissioner v. Duberstein*, 363 U.S. 278, 80 S.Ct. 1190, 4 L.Ed.2d 1218 (1960), and to ultimate factual inferences to be drawn from undisputed subsidiary findings. *Jewell Ridge Coal Corp. v. Commissioner*, 318 F.2d 695 (4 Cir. 1963). It is established that "A reviewing court is not free to draw such inferences and conclusions as it may deem proper when the evidence before the Tax Court is undisputed." *Road Materials, Inc. v. Commissioner*, 407 F. 2d 1121, 1124 (4 Cir. 1969).

The Court of Appeals' conclusion in the instant case that the question of whether there was a dividend was a question of law rather than a question of fact directly conflicts with the decisions in the above cited cases.

In *Court Holding* and *Cumberland*, the primary issue involved was that of whether there had, in substance, been a bona fide liquidating dividend by a corporation prior to the sale of its assets. The primary issue in the present case is that of whether there was in substance a bona fide dividend. The question of whether there was in substance a dividend in the present case is no more a question of law than was the question of whether there was a bona fide liquidating dividend in *Court Holding* and *Cumberland*.

In *Court Holding* this Court affirmed the Tax Court's decision based upon findings by the Tax Court that there was not a genuine liquidating dividend and that the purported liquidation of the corporation and subsequent sale of its assets by its stockholders were mere formalities. This Court there said:

> "There was evidence to support the findings of the Tax Court and its findings must therefore be accepted by the courts." (324 U.S. at 333)

In the *Cumberland* case this Court affirmed the Court of Claims' decision based upon findings by the Court of Claims that there was a genuine liquidating dividend followed by a bona fide sale by the corporate stockholders of the liquidated assets. This Court there said:

> "It is for the trial court, upon consideration of the entire transaction, to determine the factual category in which the particular transaction belongs." (333 U.S. at 456)

While this Court in its opinions in *Court Holding* and *Cumberland* frequently speaks of "whether there was a sale by the stockholders or the corporation", it is obvious that the Court must have had in mind the fundamental factual question of whether there was in substance a prior liquidating dividend because there could not have been a sale of corporate assets by the stockholders absent a prior genuine liquidating dividend.

There can be no question that in the present case the Tax Court found and concluded that Pan Atlantic did in substance declare a dividend to Petitioner. In its opinion the Tax Court said:

> Respondent argues that . . . the payment of the dividend [was a] mere subterfuge . . . [and] a device designed to give the appearance of a dividend to a part of the purchase price. (A-47)

> This is what was done. Pan-Atlantic declared a dividend to Waterman prior to the sale by Waterman of the Pan-Atlantic stock to Securities. (A-58)

> Pan-Atlantic did, in substance, declare a dividend to Waterman. (A-59)

> We, therefore, conclude that Waterman did receive a dividend of $2,799,820.00 from Pan-Atlantic prior to its sale of the Pan-Atlantic stock. (A-59)

Such findings are findings of fact and are not conclusions of law. They are based upon a careful consideration by the Tax Court of the entire transaction, as is evident from a reading of that Court's opinion, and they should have been accepted by the Court of Appeals below. An examination of the opinions of the Court of Claims in *Cumberland* (183 F.Supp. 843) and of the Tax Court in the instant case discloses that the subsidiary findings of the Tax Court are as adequate to support its above quoted findings as were those of the Court of Claims.

It is apparent from the foregoing and from the opinion of the Court of Appeals that resolution of the issue whether the distribution in question was a "dividend", or part of the purchase price, involved essentially a factual determination. While other courts of appeals have consistently followed this Court's long standing mandate that it is for the trial court to determine the factual category in which a particular transaction belongs, the Court of Appeals below avoided such mandate by saying that the case hinged on the "legal characterization" of the transactions between the parties which that Court considered to be a question of law. Such a departure from the accepted and usual course of judicial proceedings should not be sanctioned by this Court and calls for an exercise of this Court's power of supervision.

CONCLUSION

For the foregoing reasons, a Writ of Certiorari should issue to review the judgment and opinion of the Fifth Circuit.

Respectfully submitted,

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APPENDIX A

ORDER DENYING PETITION FOR REHEARING

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 27,563

WATERMAN STEAMSHIP CORPORATION,
Petitioner-Appellee,
versus
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Appeal from the Decision of the Tax Court of the United States (Alabama Case)

ON PETITION FOR REHEARING AND PETITION FOR REHEARING EN BANC
(Opinion July 15, 1970, 5 Cir., 1970, ___ F.2d ___).

(September 17, 1970)

Before WISDOM, SIMPSON and CLARK, Circuit Judges

PER CURIAM: The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that

the Court be polled on rehearing en banc, (Rule 35 Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 12) the Petition for Rehearing En Banc is DENIED.

APPENDIX B

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 27,563

WATERMAN STEAMSHIP CORPORATION,
Petitioner-Appellee,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Appeal from the Decision of the Tax Court of the United States (Alabama Case)

(July 15, 1970)

Before WISDOM, SIMPSON, and CLARK,
Circuit Judges.

WISDOM, Circuit Judge: This case involves another attempt by a taxpayer to ward off tax blows with paper armor. The issue for decision is whether the declaration and payment, in the form of a promissory note,[1] of $2,799,820 by Pan-Atlantic Steamship Corporation to its parent, Waterman Steamship Corporation, was a tax-free, intercompany dividend, as the Tax Court concluded? 50 T.C. 650. Or was it part of the purchase price paid to Waterman in a sale by Waterman of the stock of Pan-Atlantic and Gulf Florida Terminal Company to McLean Securities Company, as the Commissioner contends? If the payment is to be accorded dividend status then Waterman (because Waterman, Pan-Atlantic, and Gulf Florida filed consolidated tax returns) would be permitted to eliminate from income the dividends paid by Pan-Atlantic. Int. Rev. Code of 1954, § 1501-1504.[2] See Treas. Reg. § 1.1502-14; -31A(b) (1) (ii); -31A(b) (2) (ii) (1969). If on the other hand, the payment is to be considered part of the purchase price paid to Waterman, this payment would be included in Waterman's gross income as taxable income and the tax on the gain from the sale would be governed by Sections 1001 and 1002 of the Internal Revenue Code

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[1] The question whether a note, as a matter of law, may be issued in payment of a dividend was not litigated in the Tax Court.

[2] The statutory authorization for filing consolidated tax returns is set forth in Chapter 6 of Subtitle A of the Internal Revenue Code of 1954. Subchapter A of Chapter 6, Sections 1502-1505, pertains to filing consolidated returns and the payment of tax. Subchapter B, Sections 1551-1552 and 1561-1563, contains related rules for consolidated returns. *See* Caps, The Law Regarding Consolidated Returns, 21 S.Cal. Tax Inst. 191 (1969); Lees, New Regulations Regarding Consolidated Returns, 19 S.Cal. Tax Inst. 243 (1969).

of 1954. The Tax Court, with four judges dissenting, held that the note reflected a true dividend and was not part of the purchase price. The Tax Court's decision was predicated on the dividend distribution having been declared and paid to Waterman before the equitable, beneficial, or legal ownership of the stock had passed to the purchaser. See Treas. Reg. § 1.61-9(c) (1957). The Commissioner appeals from that decision. We reverse.[3]

I.

The record in this case presents a circular factual pattern of intriguing financial negotiations. Because we must consider the substance of the transactions, it is important to go into the facts at some length.

During 1954 and until May 5, 1955, Waterman was a publicly held corporation engaged in the steamship business throughout the world. Until January 21, 1955, Waterman was the sole owner of two subsidiary corporations, Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Incorporated. Pan-Atlantic was engaged in the coastal shipping business in the United States. Gulf Florida was engaged in the terminal, stevedoring, and steamship agency business. Each of the three companies held coastwise certifi-

[3]This appeal involves federal income taxes in the amount of $510,100.85 for the taxable period January 1, 1955, through May 5, 1955. This amount represents the Tax Court determination of an overpayment of taxes by the taxpayer and reflects the resolution of other issues not involved in this appeal. A decision in favor of the Commissioner has the effect of substituting a tax deficiency of $190,000 for the overpayment.

cates issued by the Interstate Commerce Commission. Waterman and its subsidiaries filed consolidated income tax returns for the period January 1, 1955, through May 5, 1955. Pan-Atlantic was included in the affiliated group until January 21, 1955.

In 1954, Malcolm P. McLean was the president and majority stockholder in McLean Trucking Company (Trucking).[4] Trucking was engaged in the interstate trucking business and operated under an interstate-commerce certificate issued by the ICC. During the early part of that year, McLean sought to expand Trucking's base of operations by acquiring a common carrier by water. Trucking would then be able to move trucks and highway trailers by ship between United States ports. In what is known as a "piggy back operation" the vehicles would be able to roll on and off a ship without having to unload.

McLean, through Trucking, applied to the ICC for approval of the acquisition of a common carrier by water that held an ICC coastwise certificate. Rail, water carrier, and trucking interests strongly opposed the application. McLean, concluding that ICC approval might require a four or five year struggle, withdrew the application. McLean was interested in acquiring the assets of Waterman and its subsidiaries. His attorneys advised him, however, that ICC approval would be required for such an acquisition, since Waterman and its subsidiaries held ICC certificates, and that

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[4]McLean owned approximately 58% of the one million shares of the outstanding capital stock.

his control of Trucking (also under ICC jurisdiction) would prohibit his acquiring another carrier without ICC approval. McLean's attorneys advised him that ICC approval would not be necessary if he divested himself of control in Trucking (by a management trust) and acquired the stock instead of the assets of Pan Atlantic and Gulf Florida.

Accordingly, December 20, 1954, McLean made a written offer to Waterman to purchase all of the issued and outstanding capital stock of Pan Atlantic and Gulf Florida for $3,500,000.[5] December 21, 1954, the board of directors of Waterman considered McLean's offer at a special meeting. After Waterman's president read the offer to the directors, he pointed out that there had been under consideration for some time the payment of a dividend by Pan Atlantic and Gulf Florida to Waterman of approximately $2,300,000. He stated that management's view was that the dividend should be declared and paid but that because of the adverse tax consequences he would oppose any sale of the stock before payment of the dividend. He did, however, recommend a sale of the stock for

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[5] This offer provided in part:

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> M. P. McLean of Winston-Salem, North Carolina, hereby offers to purchase all of the capital stock of Pan-Atlantic Steamship Corporation and all of the capital stock of the Gulf Florida Terminal Company, Inc., subject to the following terms and conditions.
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> 1. $3,500,000.00 in cash to be paid to Waterman Steamship Corporation for all of the capital stock of the two companies, Pan-Atlantic Steamship Corporation and the Gulf Florida Terminal Company, Inc.
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> • • •

$700,180[6] after the payment of the dividend. Since Waterman's tax basis for the stock of these two subsidiaries totalled $700,180 ($576,180 allocated to Pan Atlantic and $124,000 to Gulf Florida), a sale of these stocks for $3,500,000 would have produced a taxable gain of approximately $2,800,000. On the other hand, since the Treasury Regulations on consolidated returns provide that dividends received from affiliated corporations are exempt from tax (Sec. 1.1502-31A(b)-(1)-(i) and Sec. 1.1502-31A(b)-(2)-(iii)), a sale of stock in these subsidiary corporations for $700,000, after a dividend payment to Waterman of $2,800,000 would purportedly have produced no taxable gain.

The Board rejected McLean's offer, but authorized Waterman's president to submit a counterproposal. December 23, 1954, Waterman submitted a written counterproposal to sell to McLean, or his nominee, all of the capital stock in Pan Atlantic and Gulf Florida "at and for the price of $700,000 to be paid in cash, after the Directors . . . shall have declared and arranged for payments of dividends to the present stockholder, Waterman Steamship Corporation, amounting in the aggregate of $2,800,000". The only condition attached to the proposal was that ICC approval would not be necessary at the time of acquisition.[7]

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[6]This amount represented Waterman's tax basis in the stock of the two subsidiaries.

[7]The counterproposal provided in part:

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> 1. Waterman Steamship Corporation agrees to sell to you or to your nominee all of the capital stock which it owns in Pan Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc., which con-

During the next month, there were numerous discussions and negotiations between the officers of Waterman and McLean's representatives concerning the counterproposal. McLean's attorneys then began to formulate a plan for acquisition of the stock, which would not, in their opinion, require ICC approval. The plan they formulated required that a new corporation be formed to be the purchaser of Pan-Atlantic and Gulf Florida stock. Trucking would acquire one million shares of the stock and distribute such stock to its stockholders as a dividend on a share per share basis. McLean and his brother and sister would place their Trucking stock in an irrevocable management trust before there was any agreement or commitment to purchase the stock of Pan-Atlantic and Gulf Florida and before the new corporation or McLean acquired

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stitutes all of the issued and outstanding capital stock of said corporations, at and for the price of $700,000.00 to be paid in cash, after the Directors of said corporations shall have declared and arranged for payments of dividends to the present stockholder, Waterman Steamship Corporation, amounting in the aggregate to $2,800,000.00.

* * *

9. Without limitation as to any other conditions, this agreement is expressly conditioned upon the submission of requisite documentary proof such as will satisfy the Vice President and General Counsel of Waterman Steamship Corporation that neither you nor your nominee is a carrier subject to the provisions of Parts 1, 2 or 3 of the Interstate Commerce Act at the time of the acquisition of the stock of the two corporations as contemplated herein, and that Interstate Commerce Commission approval is not necessary with respect to the transfer of stock contemplated.

* * *

control or the power to control Pan-Atlantic or Gulf Florida.

January 14, 1955, Trucking organized McLean Securities Corporation (Securities).[8] Securities issued to Trucking one million shares of common stock at one cent a share.

January 17, Trucking declared and paid as a dividend one share of Securities common stock on each share of the one million shares of outstanding Trucking stock.[9] At this same time, arrangements were made to place McLean's Trucking stock in the management trust. This was necessary so that when Securities acquired the stock of the two subsidiaries, the person in control of Securities, McLean, would not be in control of a carrier. McLean's attorneys believed that ICC approval would be required if an entity, controlled by a person who controlled another carrier, acquired the stock of Pan-Atlantic and Gulf Florida. According to the terms of the trust agreement McLean would divest himself of control over the stock and operation of the company and such control would be placed in the trustee.

January 20, McLean and his attorneys, after receiving the assent of the United States Trust Company to

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[8]The name of this corporation was subsequently changed to McLean Industries Incorporated.

[9]As a result of the dividend payment, McLean received approximately 580,000 shares of Securities. McLean then purchased 190,000 additional shares of the stock, bringing his holdings in Securities to 770,000 shares.

act as trustee for the management trust, went to Mobile, Alabama, where Waterman had its principal office. Although no firm agreement had been reached as of January 20, McLean went to Mobile expecting to complete the negotiations for the acquisition of the stock of Pan Atlantic and Gulf Florida.

On the morning of January 21, McLean's attorney went to the office of Waterman's general counsel to review the proposed purchase agreement prepared by Waterman. At the same time, Waterman's general counsel reviewed the proposed trust agreement prepared by McLean's attorney. At noon on January 21, the board of directors of Pan Atlantic met and declared a dividend of $2,799,820 to its stockholders of record on January 20. Since Pan Atlantic did not have available sufficient cash to pay the dividend, the dividend was declared in the form of a promissory note in the amount of $2,799,820.[10] The note was payable on or before February 20, 1955.[11] The dividends were paid

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[10]There is no dispute that Pan-Atlantic had earnings and profits of at least $2,799,820 as of January 21.

[11]The minutes of the meeting at which the dividend was declared:

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> He [Waterman's president] recommended to the Directors that such dividend be declared, but, inasmuch as the corporation does not have available at this time sufficient cash to pay this dividend and also a dividend which he is proposing to recommend on the Common stock, he recommended, further, that this dividend be declared and be paid by and in the form of a promissory note of Pan-Atlantic Steamship Corporation, to be executed and delivered forthwith upon declaration of the dividend to Waterman Steamship Corporation, its sole stockholder, payable on or be-

by the execution and delivery of the note.

At 12:30 p.m., a special meeting of the board of directors of Securities was held to authorize the purchase and financing of all of the stock in the two companies. The minutes of that meeting reflect that Securities and McLean were to lend Pan-Atlantic $279,820 after the stock purchase.

At 1:00 p.m., a meeting of the board of directors of Waterman was held to discuss the sale of the stock in the two companies. Waterman's president stated that the Company had received a promissory note of $2,799,820 in payment of dividends on its Pan Atlantic stock and that McLean, through Securities, would be able to purchase the subsidiaries without ICC approval. He then recommended that both the preferred and

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fore February 20, 1955, bearing interest at the rate of 4% per annum.

The Chairman said that, inasmuch as there remains sufficient surplus net assets for such purpose after declaration of the dividend as above provided on the Preferred stock, he would recommend the declaration of a dividend on the Common stock in the amount of $2,689,374.00, to be paid by and in the form of a promissory note of Pan-Atlantic Steamship Corporation, to be executed and delivered, forthwith upon declaration of the dividend, to Waterman Steamship Corporation, its sole stockholder, payable on or before February 20, 1955, with interest at 4% per annum.

He recommended that the dividend on the Preferred stock and the dividend on the Common stock, if declared, be declared payable and deliverable in the form of one promissory note, as above outlined, to stockholders of record as at the close of business on January 20, 1955.

* * *

common stock of Pan-Atlantic and the common stock of Gulf Florida be sold to Securities for $700,180. The board approved the sale.

Waterman's president then informed McLean of the board's approval of the proposed sale. It was at this time that McLean executed the trust agreement divesting himself of control of Trucking. The closing agreement for the sale of the subsidiaries' stock was then executed.[12]

At 1:30 p.m., the new board of directors of Pan-Atlantic held a special meeting. McLean presided. The board authorized the corporation to borrow $2,500,000 from McLean personally and $299,820 from Securities. Notes for these amounts were delivered to McLean and Securities. Pan-Atlantic then issued a check to Waterman for $2,799,820 in payment of the note Pan-Atlantic had issued to Waterman for the dividend.[13]

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[12]This agreement provided in part:

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> Without limitation as to any other agreement to guarantee or indemnify Waterman against loss in this instrument contained, McLean guarantees prompt payment and discharge of the respective liabilities and obligations of Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc., to all persons whomsoever as reflected by the books of Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc., on the date of this instrument, including but without limitation, payment of any note or notes given by either corporation as a dividend, declared prior to the date hereof.
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> • • •

[13]The $2,500,000 McLean lent to Pan-Atlantic was borrowed from Bethlehem Steel Corporation. That loan was made immediately following the purchase of the subsidiaries' stock by Securities. The record reflects that the negotiations for the loan had been in progress for some time prior to January 21, 1955.

By the end of the day and within a ninety minute period, the financial cycle had been completed. Waterman had $3,500,000, hopefully tax-free, all of which came from Securities and McLean, the buyers of the stock.[14]

II.

Waterman in its consolidated income tax return, eliminated from income the $2,799,820 received as a dividend from Pan-Atlantic and reported $700,180 as the sales price for the stock of the two subsidiaries. Since Waterman's tax basis for the stock totalled $700,180, no taxable gain was realized on the sale. The Commissioner, however, determined that Waterman had realized a long-term capital gain of $2,799,820 on

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[14]May 5, 1955, C. Lee Co., Inc., a wholly-owned subsidiary of Securities purchased substantially all of the Waterman stock for cash. July 6, McLean transferred Pan-Atlantic's note of $2,500,000 to Securities in exchange for 50,000 shares of preferred stock in Securities. The reason for this transfer was that there was a public underwriting of stock of Securities and the underwriter insisted that the $2,500,000 indebtedness not be owed by Securities' subsidiary Pan-Atlantic, in the principal sum of $2,500,000 and $299,820, to Waterman for cash. July 21, 1958, Waterman declared a dividend in kind to Securities of the $2,500,000 note. Subsequently, Securities contributed the $2,500,000 to Pan-Atlantic as paid-in capital by marking the note paid. Later in the year, Pan-Atlantic paid Waterman $299,820 in settlement of its note. In characterizing these facts, the dissent stated:

> McLean offered to pay $3,500,000 as the purchase price and that is precisely the amount it finally paid. When the transaction was completed, Pan-Atlantic was no richer and no poorer than it had been at the start. Only a portion of its accumulated earnings and profits had been converted to capital.

50 T.C. at 667.

the sale of the stock and increased its taxable income accordingly. Waterman petitioned the Tax Court for a redetermination of the asserted deficiency.

At the trial[15] Waterman attempted to establish that it was the equitable as well as the legal owner of the stock of Pan-Atlantic when the dividend was declared; that Pan-Atlantic's note for $2,799,820 was payment of the dividend while Waterman was the legal and equitable owner of the stock; and that because the dividend was declared and paid while Waterman was the legal owner and equitable owner of the stock in Pan-Atlantic, the $2,799,820 constituted a dividend paid by Pan-Atlantic to Waterman. In support of its position, Waterman pointed to Treas. Reg. § 1.61-9(c) (1957) which provides that:

> When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller.

Waterman continually stressed the fact that it had a sound business reason for pursuing the method it followed in disposing of Pan-Atlantic and Gulf Florida. A stock sale, Waterman argued, was the only way its subsidiaries could have been sold to McLean without ICC approval, and had it not been for ICC approval

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[15]The case was tried upon a stipulation of facts and the testimony of two witnesses, Malcolm P. McLean and Thomas Higginson, one of McLean's attorneys. The substance of their testimony is embodied in the stipulation and need not be detailed.

the same result could have been accomplished without any taxable gain.[16]

The Commissioner did not argue that the legal or equitable ownership of the stock had passed from Waterman to Securities before the declaration or payment of the dividend on January 21. Rather, the Commissioner adopted the position that irrespective of the form of the transaction, the substance of the transaction was a payment by Securities to Waterman of $3,500,000 for the stock of the subsidiaries. The entire procedure, the Commissioner contended, was a device designed to give the appearance of a dividend to a part of the purchase price of the stock, and that no purpose was served by causing a part of the purchase of the stock to be labeled a "dividend" except the avoidance of an income tax by Waterman.

As the Tax Court correctly stated: "The crux of the problem here is whether the planned form of the transaction had sufficient substance so that it should be

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[16]Waterman premised this argument on the fact that Pan-Atlantic's adjusted basis, for tax purposes, of its assets, less its liabilities, exceeded $3,500,000 at the time of sale. Waterman hypothesized that the transaction could have taken the form of a complete liquidation of Pan-Atlantic under Sections 332 and 334 of the Internal Revenue Code of 1954 without any change in the basis of the assets, followed by a sale of these assets by Waterman to Securities; or Pan-Atlantic could have sold its assets directly to Securities followed by a liquidation under Section 332; or Pan-Atlantic could have merged into Waterman with no change in the basis of the assets under Sections 3689(a) (1) (A) and 362(b) of the Code followed by a sale of the assets to Securities.

recognized for tax purposes." 50 T.C. at 661.[17] After reviewing the chain of events leading to the purchase agreement of January 21 and the inferences to be drawn, the court held that the note paid to Waterman by Pan-Atlantic before the sale of its stock was properly deducted as a tax exempt inter-corporate dividend.

The Tax Court reached its ultimate conclusion not withstanding the fact that it had earlier concluded that Waterman's sole objective was to receive $3,500,000 with approximately $2,800,000 of the designated price as a dividend which would be eliminated from income and with none of the assets of the subsidiaries being removed from those companies before the sale of the stock. The court also concluded that since Pan-Atlantic did not have available sufficient cash to pay the dividend to Waterman, it was understood between the parties that McLean would arrange promptly after the sale of the stock to supply Pan-Atlantic with sufficient funds to pay the dividend note.

Judge Tannewald, dissenting, thought that the majority had failed to recognize the basic issue: "We are not called upon to decide to whom a conceded dividend should be taxable as such but rather whether there was any dividend at all." Relying upon *Gregory v. Helvering*, 1935, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596,

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[17]Commenting upon the Tax Court's decision, Mertens, Law of Federal Income Taxation, § 9.109, at 360-61 (1961) states:

> A question may arise as to whether or not a dividend was actually declared or was merely a device designed to give the appearance of a dividend to part of the purchase price paid for stock of a corporation.

Judge Tannewald concluded that: "The plain unadulterated fact is that no dividend was declared or paid by Pan-Atlantic to Waterman or anyone else. The note issued by Pan-Atlantic was merely a piece of paper, which served only a temporary purpose and disappeared." 50 T.C. at 667.

On appeal, the Commissioner takes the position that the Tax Court's conclusions are inconsistent with the court's own findings and are contrary to the principle that tax consequences are to be governed by the substance not the form of the transactions. The Commissioner argues that the court resolved the question in this case by applying rules applicable to situations where a regular dividend had concededly been declared and the only issue was who was to be taxed. Those rules, the Commissioner contends, are not applicable when, as in this case, the parties contemplate that a purported dividend is to be inextricably tied to the purchase price and where, as here, the amount of the dividend is not a true distribution of corporate profits. Here the distribution of funds was supplied by the buyer of the stock, with the corporation acting as a mere conduit for passing the payment through to the seller.

We agree with the Commissioner. The so-called dividend and sale were one transaction. The note was but one transitory step in a total, pre-arranged plan to sell the stock. We hold that in substance Pan-Atlantic neither declared nor paid a dividend to Waterman, but rather acted as a mere conduit for the payment of the purchase price to Waterman.

III.

Waterman argues, first, that the Tax Court's ultimate conclusion that the distribution from Pan-Atlantic was a dividend and not part of the purchase price is one of fact which should not be set aside unless clearly erroneous. Waterman contends that the intent of the parties has a controlling significance on the issue; that motive, intent, and conduct are matters solely within the purview of the fact-finder.

We are not persuaded by Waterman's argument. This Court answered a similar argument in *Berkowitz v. United States*, 5 Cir. 1969, 411 F.2d 818, 821.

> The problem however, is not one of ascertaining "intent" since the parties have objectively manifested their intent. It is a problem of whether the intent and acts of the parties should be disregarded in characterizing the transaction for federal tax purposes.

This case hinges on the legal characterization, for federal tax purposes, of the transactions between the parties. That characterization is not a question of fact but rather one of law. *See Union Planters Nat'l Bank v. United States*, 6 Cir. 1970, F.2d [No. 19,409, May 4, 1970]. *See also* Bittker and Eustice, Federal Income Taxation for Corporations and Shareholders, 17 (2d ed. 1966).

The case was tried upon a stipulation of facts entered into by the parties and accepted by the Tax Court.

It is incumbent upon this Court to inquire into the correct application of the tax law to the undisputed facts. The Tax Court's legal conclusion that the distribution here was a "dividend" and not part of the purchase price is persuasive but does not tie this Court's hands in reaching a different conclusion.

IV.

Gregory v. Helvering, 1935, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596, established that tax consequences must turn upon the economic substance of a transaction and not upon the timing sequences or form of the transaction. *See also Barnett v. Commissioner*, 2 Cir. 1966, 384 F.2d 742. "To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation". *Higgins v. Smith*, 1940, 308 U.S. 473, 477-78, 60 S.Ct. 355, 84 L.Ed. 406, 411. *See Goldstein v. Commissioner*, 2 Cir. 1966, 364 F.2d 734. But the solution of hard tax cases requires something more than the easy generalization that the substance rather than the form of a transaction is determinative of its tax effect. *Gregory* should not be considered a "talisman of magical powers", since in numerous situations the form by which a transaction is effected does influence or control its tax consequences. *Edwards v. Commissioner*, 10 Cir. 1969, 415 F.2d 578. This generalization does however, reflect the truth that courts will look beyond the superficial formalities of a transaction to determine the proper tax treatment. *See American Nat'l Bank v. United States*, 5 Cir. 1970, 421 F.2d 442, petition for cert. filed, 38 U.S.L.W. 3516 (No. 1587, May

18, 1970); *U.S. v. General Geophysical Co.*, 5 Cir. 1961, 296 F.2d 86; *Alpha Tank's Sheet Metal Mfg. Co. v. United States*, Ct. Cl. 1953, 116 F.Supp. 721.

Gregory involved the creation of a corporate entity for the purpose of transferring shares of stock to the taxpayer. While recognizing that a valid corporate entity was created and that the transaction had complied precisely with the formal requirements of the statute, the Court concluded that it was "an elaborate and devious form of conveyance masquerading as rate reorganization . . . ." 293 U.S. at 470, 79 L.Ed. at 599. The activities were described as

> [s]imply an operation having no business purpose or corporate purpose . . . a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.

Id. at 469, 79 L.Ed. at 599. The Court there also referred to the rule which excludes from consideration the motive of tax avoidance but determined that it was not pertinent to the situation "because the transaction upon its face lies outside the plain intent of the statute". Id. at 470, 79 L.Ed. at 599.

Judge Learned Hand has best expressed the protean concept evolved from Gregory:

> If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; *for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.* (Emphasis added.)

Gilbert v. Commissioner, 2 Cir. 1957, 248 F.2d 411-12 (dissenting on a procedural matter).

The *Gregory* principle has not been limited to corporate reorganizations, but has been applied to federal taxing statutes in general. E.g., *Higgins v. Smith*, *supra*; *Commissioner v. Court Holding Co.*, 1945, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981; *Rutledge v. United States*, 5 Cir. 1970, F.2d [No. 28,432, June 22, 1970]; *Kanawha Gas & Utilities Co. v. Commissioner*, 5 Cir. 1954, 214 F.2d 685. The words of the taxing statutes which describe commercial transactions are therefore to be understood to refer to transactions entered into for commercial purposes. Transactions entered into not for commercial purposes but only to escape taxation are suspect.[18]

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[18] "Although Gregory [v. Helvering, 293 U.S. 465 (1935)] may mean all things to all men, its essence is an instinctive judicial attitude that a transaction should not be given effect for tax purposes unless it serves a purpose other than tax avoidance. Thus, a transaction heavily laden with tax avoidance motives may be disregarded as a 'sham', or its form may be recast to reflect its economic 'substance' . . . in order to prevent overreaching taxpayers from doing indirectly what they cannot do directly." Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 555 (2d ed. 1966).

Gregory does not per se preclude a taxpayer from decreasing his taxes or avoiding them by methods permitted by law. The application of that principle does not mean however that a person may reduce his tax liability by transferring his money from one pocket to another even though he uses different pairs of trousers. *Minnesota Tea Co. v. Helvering*, 1938, 302 U.S. 609, 58 S.Ct. 393, 82 L.Ed. 474. We stated in *Kanawha Gas*

> In determining the incidence of taxation, we must look through form and search out the substance of a transaction.... This basic concept of tax law is particularly pertinent to cases involving a series of transactions designed and executed as parts of a unitary plan to achieve an intended result. Such plans will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation. The series of closely related steps in such a plan are merely means by which to carry out the plan and will not separate.

214 F.2d at 691.

The inability of a taxpayer to cast what in substance is a unitary transaction in the form of a two step transaction is reflected in this Court's decision in *Redwing Carriers, Inc. v. Tomlinson*, 5 Cir. 1968, 399 F.2d 652. In *Redwing Carriers* the taxpayer sought to recognize an immediate gain at capital gains rates and then take a large depreciation deduction from ordinary income by shaping what was essentially an integrated pur-

chase and trade-in transaction of new and used motor vehicles into two separate transactions. We held that what was in substance a tax-free exchange could not be transformed into two sales by the arbitrary separation of time and exchange of cash in order to circumvent Section 1031 of the Internal Revenue Code of 1954. *See Reef Corp. v. Commissioner*, 5 Cir. 1966, 368 F.2d 125; *Davant v. Commissioner*, 5 Cir. 1966, 366 F.2d 874.[19]

We do not dispute that consistency of decision in the federal tax field is indispensable for taxpayers and their advisors who need to predict the tax consequences of their transactions. Yet what frequently appears on cursory examination, as a sport among tax cases precedent is actually a permutation spawned by facts of some particular case. *See Britt v. United States*, 5 Cir. 1970, F.2d , [No. 27,310, May 14, 1970, p. 11-12.] *Compare Bullen v. Wisconsin*, 1916, 240 U.S. 625, 630-631, 36 S.Ct. 473, 60 L.Ed. 830 *with Proctor & Gamble Co. v. Hewton*, S.D.N.Y. 1923, 289 F. 1013. Each case therefore must be decided on its

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[19]American Nat'l Bank v. United States, 5 Cir., 1970, 421 F.2d 442 petition for *cert. filed*, 38 U.S.L.W. 3516 (No. 1587, May 18, 1970); and Union Planters Nat'l Bank, 6 Cir. 1970, F.2d [No. 19,409, May 4, 1970], involved the question of whether coupon interest collected by banks as owners of municipal bonds subject to a repurchase agreement with bond dealers was exempt from taxation under § 103(a) of the Code. In both cases, the Court's of Appeals reserved the district courts determination characterizing the arrangement as a sale-repurchase transaction.

> In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities and formal written documents are not rigidly binding.
>
> F.2d .

own merits by examining the form and substance of the transactions to determine whether recognition of the form of the transaction would undermine relevant tax provision.

Here, McLean originally offered Waterman $3,500,000 for the stock of Pan-Atlantic and Gulf Florida. Waterman recognized that since its basis for tax purposes in the stock was $700,180, a taxable gain of approximately $2,800,000 would result from the sale. It declined the original offer and proposed to cast the sale of the stock in a two step transaction. Waterman proposed to McLean that it would sell the stock of the two subsidiaries for $700,180 after it had extracted $2,800,000 of the subsidiaries' earnings and profits. It is undisputed that Waterman intended to sell the two subsidiaries for the original offering price — with $2,800,000 of the amount disguised as a dividend which would be eliminated from income under Section 1502. Waterman also intended that none of the assets owned by the subsidiaries would be removed prior to the sale. Although the distribution was cast in the form of a dividend, the distribution was to be financed by McLean with payment being made to Waterman through Pan-Atlantic. To inject substance into the form of the transaction, Pan-Atlantic issued its note to Waterman before the closing agreement was signed. The creation of a valid indebtedness however, cannot change the true nature of the transaction. *Goldstein v. Commissioner*, 2 Cir. 1966, 364 F.2d 734.

Waterman argues that it had a sound business purpose in casting the transaction as it did: ICC regula-

tions prohibited McLean from acquiring the assets of Waterman or its subsidiaries. In the circumstances of this case, we do not dispute the soundness or the necessity of a stock acquisition rather than an asset acquisition. This argument, however, overlooks the fact that there was no requirement imposed by the ICC for dividing the stock sale into two parts. The only party that required the transaction to be cast as it was, was Waterman. Once McLean divested himself of control of Trucking, he was free to pay $3,500,000 in cash directly to Waterman without any necessity of using Pan Atlantic as a conduit for the payment of $2,800,000 in the guise of a "dividend". An integrated transaction cannot be separated into its components for the purpose of avoiding taxation. *See Blackstone Realty Co. v. Commissioner*, 5 Cir. 1968, 398 F.2d 991.

The fact that Waterman may have cast the transaction in a different way so as to result in no taxable gain offers no solution. We concentrate on what the parties did. *Wilson v. Commissioner*, 5 Cir. 1958, 255 F.2d 702, *aff'g* 1957, 27 T.C. 976. The form of the transaction used by the parties is relatively unimportant, for the true substance and effect of their agreement was that McLean would pay $3,500,000 for all of the assets, rights and liabilities represented by the stock of Pan-Atlantic and Gulf Florida. It is less than realistic to suppose that the amount ultimately agreed to be paid as the purchase price under the agreement was not lessened because Waterman removed the designated surplus for the sole purpose of circumventing the ad-

verse tax consequences. The distribution here clearly affected the quantum of the purchase price with McLean ultimately paying $3,500,000.

Waterman also argues and cites many authorities to support its position that since it was both the legal and beneficial owner of the stock when the dividend was declared, the dividend belonged to Waterman. *See, e.g., Steel Improvement & Forge Co. v. Commissioner*, 6 Cir. 1963, 314 F.2d 96, *reversing* 1961, 36 T.C. 265. Those cases were concerned with corporate distributions which were concededly dividends; the only issue was determining whether the seller or the buyer of the stock was to be deemed the recipient of the dividend. Nor is the lack of a binding agreement affirmatively demonstrating that Waterman was the beneficial owner of the stock when the dividend was declared dispositive of the issue. *See United States v. General Geophysical*, 5 Cir. 1956, 296 F.2d 86. The Tax Court's conclusion that Waterman was in substance both the legal and beneficial owner of the stock when the dividend was declared does not answer the question whether in substance a dividend was declared.

> The test of whether events should be viewed separately or together as part of a single plan is not temporal but is functional.

Reef Corp. v. Commissioner, 5 Cir. 1966, 368 F.2d 125, 134. *See Aull v. Commissioner*, 1932, 26 B.T.A. 862.

A new horizon of tax avoidance opportunities would be opened by allowing a tax free dividend, under Section 1502, to result from the transaction here effected. Corporations with wholly-owned subsidiaries would be enabled, without difficulty, to circumvent capital gains treatment through a pre-sale extraction of earnings and profits. The Regulations promulgated under Section 1502 of the Code allow the recipient in an affiliated group of corporations to eliminate from income a "dividend distribution" received from another member of that group. A pre-sale extraction however, conflicts with the concept of a dividend as a distribution of earnings and profits made in the context of an ongoing corporation-shareholder relationship. *See generally* Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 148 (2d ed. 1966). Potential circumvention does not stop there. If the court should accept Waterman's view of the transaction, a corporation could purchase another corporation at its fair market value, receive its new subsidiaries' earnings and profits in the form of an inter-corporate dividend, sell the subsidiary, and then claim a loss on the subsequent sale. In this light, a subsidiary's dividend declaration immediately before the complete disposition of the parent's interest in the stock of the subsidiary seems a hollow device lacking any business objective other than the extraction of earnings and profits without dividend consequences. This is especially so when there is reason to believe, as the Tax Court believed, no di-

vidend would have been paid but for the contemplated sale.[20]

These tax avoidance implications do not however, constitute a license to courts to distort the law, to write in new provisions, or to render present provisions nullities; they do mean that we should guard against giving force to "a purported |dividend| which gives off an unmistakeably hollow sound when it is tapped." *United States v. General Geophysical Co.*, 5 Cir. 1961, 296 F.2d 86, 89. The undisputed facts and the inferences to be drawn from the facts will not support a holding that Waterman received what in tax terms should be described functionally as a dividend from Pan-Atlantic.

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[20]In United States v. General Geophysical Company, 5 Cir. 1961, 296 F.2d 86, a corporation transferred certain depreciable assets to its shareholders in redemption of their stock and later the same day reacquired them for corporate notes, claiming a stepped-up basis for these assets. This Court held the transfer invalid for income tax purposes, despite the fact that there was no legal commitment on the shareholders' part to resell these assets to the corporation. We said: 'The taxpayer asserts that the transactions were prompted by a valid business purpose and were effected without a motive of tax avoidance. We accept these assertions, which are supported by the trial judge's findings, as true. They lend support to the taxpayer's case, but they do not control the disposition of the case. Intent often is relevant in questions of taxation, particularly where the bona fides of a transaction is called into question, but in most cases tax treatment depends on what was done, not why it was done. And our decision in this case rests not on the motivation of the transactions in question but rather on our conclusion that the admitted facts of the two transfers preclude a finding of a sufficient hiatus in the corporate ownership of the assets to justify bestowal of a new basis on them after the reacquisition." Id. at 89.

Judge Goldberg, speaking for the Court in *Redwing Carriers* stated:

> Taxation is transactional and not cuneiform. Our tax laws are not so supple that scraps of paper, regardless of their calligraphy, can transmute (a payment received for the sale of stock into an intercorporate tax free dividend). A taxpayer may engineer his transactions to minimize taxes, but he cannot make a transaction appear to be what it is not. Documents record transactions, but they do not always become the sole criteria for transactional analysis.

399 F.2d at 659.

The views Judge Goldberg expressed in *Redwing Carriers* are applicable here.

The judgment of the Tax Court is REVERSED with directions to enter final judgment for the Commissioner.[21]

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[21]Our decision today should not be interpreted as standing for the proposition that a corporation which is contemplating a sale of its subsidiary's stock could not under any circumstances distribute its subsidiaries profits prior to the sale without having such distribution deemed part of the purchase price. In the context of this case, we consider the distribution to be part of the purchase price and not a dividend.

THE JUDGMENT OF THE COURT OF APPEALS APPEARS AT APPENDIX E (A-73)

APPENDIX C

OPINION OF THE TAX COURT OF THE UNITED STATES
50 T.C. 630

Filed: July 31, 1968

SCOTT, *Judge*: Respondent determined a deficiency in petitioner's income tax for the taxable period January 1, 1955, through May 5, 1955, in the amount of $196,744.93.

Some of the issues raised by the pleadings have been disposed of by agreement of the parties leaving for our decision whether the distribution of a promissory note by Pan-Atlantic Steamship Corp. in the principal sum of $2,799,839 to Waterman Steamship Corp. was a dividend or part of the purchase price for the sale by Waterman Steamship Corp. of the stock of Pan-Atlantic Steamship Corp. and Gulf Florida Terminal Co., Inc., to McLean Securities Corp.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioner was incorporated under the laws of the State of New York on April 27, 1935, and had its principal office in Mobile, Ala. at the date of the filing of the petition in this case. Petitioner is the successor by merger to Waterman Steamship Corp. (hereinafter

referred to as Waterman) which was incorporated under the laws of the State of Alabama and which had its principal office at Mobile, Ala. Pursuant to the terms of the merger agreement which was in compliance with the laws of New York and Alabama, Waterman Steamship Corp., the New York corporation, was the corporation surviving the merger which occurred on or about May 11, 1955. Petitioner assumed all of the obligations and liabilities and succeeded to all of the properties, assets, rights, claims, and interests of the Alabama corporation.

Petitioner's predecessor and its subsidiaries filed a consolidated U.S. Corporation Income Tax Return for the period January 1, through May 5, 1955 with the district director of internal revenue at Birmingham, Ala. Pan-Atlantic Steamship Corp. was included in the consolidation until January 21, 1955.

During the year 1954 and until January 21, 1955, Malcom P. McLean (hereinafter referred to as McLean) was the president, a director, and the majority stockholder of McLean Trucking Co., a North Carolina corporation (hereinafter referred to as Trucking).

Trucking was engaged in the trucking business as a common carrier under a certificate issued by the ICC and was subject to ICC regulation. In January of 1955 Trucking had approximately 1 million shares of common stock outstanding, and was a publicly held and publicly traded corporation. McLean owned approximately 38 percent of the stock of Trucking, his brother James owned approximately 10 percent, and

his sister Clara owned approximately 3 percent. James and Clara were also officers and directors of Trucking.

During the year 1954 McLean became interested in transporting the trailers hauled by tractor trucks on ships between certain ports in the United States. He contemplated moving highway trailers by ship between the major U.S. ports in the Gulf of Mexico and parts of the eastern seaboard of the United States. This operation is sometimes referred to as a "piggy back" by water operation. He contemplated rolling trailers on and off the ship without having to unload the cargo from the trailer and therefore needed ships suitable for such purpose.

In early 1954 McLean had Trucking attempt to acquire a business which was a common carrier by water from Key West, Fla., to Portland, Maine. Trucking filed an application for ICC approval of the acquisition. There was opposition to such approval from the trucking, water carrier, and railroad industries. Because of the amount of opposition to Trucking's proposed acquisition, McLean was of the opinion that action on the application would not be taken for 4 or 5 years.

McLean began looking for a coastwise water carrier with sufficient assets that he would be willing to make the purchase if it required his disposing of his stock in Trucking in order to avoid obtaining the approval of the ICC for the purchase.

Waterman was the sole owner of two subsidiaries named Pan-Atlantic Steamship Corp. (hereinafter re-

ferred to as Pan-Atlantic) and Gulf Florida Terminal Co., Inc. (hereinafter referred to as Gulf Florida). Waterman during 1954 and until May 5, 1955, was a publicly held corporation. It was engaged in the steamship business between ports throughout the world during 1954 and 1955 and has continued to be so engaged. Pan-Atlantic was engaged in the coastwise shipping business between U.S. ports. Gulf Florida was engaged in the terminal, stevedoring, and steamship agency business.

McLean originally considered making an offer to purchase the stock or assets of Waterman. However, because Waterman and two of its subsidiaries, Pan-Atlantic and Gulf Florida, each held ICC certificates and because Waterman and Pan-Atlantic were both water carriers, for a noncarrier to have acquired control of Waterman would in the opinion of McLean's advisers, have required approval by the ICC. Therefore, even if McLean divested himself of any interest in Trucking, he was of the opinion that he could not have acquired control of Waterman without ICC approval.

After receiving advice from his attorneys that his acquisition of control of Waterman could not be arranged in such a manner as not to require approval by the ICC, McLean presented to Waterman a written offer, dated December 20, 1954, to purchase all of the issued and outstanding capital stock of Pan-Atlantic and of Gulf Florida. This offer provided in part as follows:

M. P. McLean of Winston-Salem, North Carolina, hereby offers to purchase all of the capital stock of Pan-Atlantic Steamship Corporation and all of the capital stock of the Gulf Florida Terminal Company, Inc. subject to the following terms and conditions.

1. $3,500,000.00 in cash to be paid to Waterman Steamship Corporation for all of the capital stock of the two companies, Pan-Atlantic Steamship Corporation and the Gulf Florida Terminal Company, Inc.

• • • • •

7. On closing date to be agreed upon by Waterman and the purchaser and simultaneously with the payment for the stock, a meeting of the Board of Directors of Pan-Atlantic Steamship Corporation and the Gulf Florida Terminal Company, Inc. shall be held, the present directors shall resign and nominees of the purchaser shall be elected to constitute all of the then members of the board, and these nominees shall take their position as such Directors at this meeting.

This offer was intended as an offer by McLean or his nominee. Although McLean was interested in acquiring the assets of Pan-Atlantic, the offer was made to purchase the stock because in an asset acquisition the ICC certificate held by Pan-Atlantic could not have been transferred without ICC approval.

The board of directors of Waterman met on December 21, 1954, to consider McLean's offer. After reading the offer to the board of directors, Waterman's presi-

dent pointed out that there had been under consideration for some time the payment of a dividend by either Pan-Atlantic or Gulf Florida to Waterman in an amount of over $2,500,000, that it was the view of management that such a dividend could and should be paid, and that because of the tax consequences he would oppose any sale of the stock prior to payment of the dividend, but would consider favorably recommending a sale of the stock after the payment of the dividend. Upon the recommendation of Waterman's president, the board rejected McLean's $3,500,000 cash offer for the stock of Pan-Atlantic and Gulf Florida, but agreed to make a counteroffer. The board adopted the following resolution:

BE IT RESOLVED that Mr. N. Nicholson, President of Waterman Steamship Corporation, be and he is hereby authorized and directed to advise Mr. M. P. McLean of Winston-Salem, North Carolina, that the Directors of Waterman Steamship Corporation have declined to accept and have refused his written offer made under date of December 20, 1954 with respect to the purchase of the capital stock of Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc.; and

BE IT FURTHER RESOLVED that Mr. Nicholson, as President of Waterman Steamship Corporation, be and he is hereby authorized and directed to make a written counter-proposal to Mr. McLean substantially in the form of the draft of a counter-proposal as submitted to this meeting; and

BE IT FURTHER RESOLVED that the Vice President & Treasurer and the Vice President & General Counsel of Waterman Steamship Corporation be and they are hereby directed to give study and consideration to the matter of the payment of dividends by Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc., one or both, in the aggregate not exceeding $2,000,000.00, and to make a recommendation as to the most suitable method and form for declaring and paying such dividend or dividends; and

BE IT FURTHER RESOLVED that the draft of the counter-proposal hereby directed to be made to Mr. M. P. McLean be and the same hereby is ordered attached to and made a part of these minutes.

Pursuant to the authorization of the board of directors, Waterman, by its president, wrote a letter to McLean dated December 23, 1954, declining to accept McLean's offer of December 20, 1954, as made, and making a counterproposal offering to sell McLean or his nominee all of the capital stock of Pan-Atlantic and Gulf Florida upon and subject to, among others, the following terms and conditions:

1. Waterman Steamship Corporation agrees to sell to you or to your nominee all of the capital stock which it owns in Pan Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc., which constitutes all of the issued and outstanding capital stock of said corporations, at and for the price of $700,000.00 to be paid in cash, after the Directors of said corporations shall have declared and arranged for payments

of dividends to the present stockholder, Waterman Steamship Corporation, amounting in the aggregate to $2,000,000.00.

• • • •

8. Upon a closing date not later than February 1, 1955, to be agreed upon by Waterman Steamship Corporation and you or your nominee, and simultaneously with the delivery of the stock and the payment therefor, a meeting of the Board of Directors of Pan Atlantic Steamship Corporation and a meeting of the Directors of Gulf Florida Terminal Company, Inc., shall be held, the present Directors shall resign, and your nominees, or those of your nominee, shall be elected to constitute all of the then members of the Boards and such nominees shall assume their positions as Directors at such meetings.

9. Without limitation as to any other conditions, this agreement is expressly conditioned upon the submission of requisite documentary proof such as will satisfy the Vice President and General Counsel of Waterman Steamship Corporation that neither you nor your nominee is a carrier subject to the provisions of Parts 1, 2 or 3 of the Interstate Commerce Act at the time of the acquisition of the stock of the two corporations as contemplated herein, and that Interstate Commerce Commission approval is not necessary with respect to the transfer of stock contemplated.

In the event this agreement, with respect to the purchase of stock and the payment therefor, shall not have

been carried out and completed on or ptior to February 1, 1955, this agreement shall be null and void.

Discussions and negotiations between officers of Waterman and McLean ensued during the next month pertaining to the proposed sale of the stock of Pan-Atlantic and Gulf Florida.

On December 27, 1954, McLean contacted his legal counsel in New York City and from that date through January 21, 1955, remained in frequent contact with his attorneys. From December 27, 1954, through January 21, 1955, McLean's attorneys worked steadily in arranging and formulating a method for acquisition of the stock which would not require ICC approval and resolving other problems involved in the acquisition which was the subject of the counteroffer made to McLean.

On January 14, 1955, Trucking organized McLean Securities Corp., a Delaware corporation, the name of which was later changed to McLean Industries, Inc. (hereinafter referred to as Securities). Securities initially issued to Trucking 1 million shares of common stock at 1 cent per share or $10,000 cash. Shortly thereafter, Malcolm, James, and Clara McLean and Garrard Winston paid for additional shares of Securities. McLean purchased 190,000 shares and Winston purchased 10,000 shares.

On Monday, January 17, 1955, Trucking declared and shortly thereafter paid a dividend of one share of Securities common stock on each of the 1 million shares

of outstanding Trucking stock. After the payment of such dividend, Securities was publicly traded in the over-the-counter market. Arrangements were being made to place the stock of Trucking owned by McLean and his brother and sister in a management trust so that when Securities would acquire the stock of Pan-Atlantic and Gulf Florida, the person in control of Securities (McLean) would not be in control of a carrier since if an entity controlled by a person who controlled another carrier acquired the stock of Pan-Atlantic and Gulf Florida, ICC approval of the acquisition might be required. On January 21, 1965, the trust agreement with respect to the Trucking stock of McLean, his brother, and sister was executed. Under the agreement the beneficial owners of the stock were divested of all control over the stock or operation of the company and such control placed in the trustee.

McLean and his attorney went to Mobile, Ala., late on January 20, 1965. The agreement of the company selected to act as trustee of the trust to which the Trucking stock was to be transferred was not finally secured until the afternoon of January 20, 1965. Other arrangements which McLean found it necessary to make were concluded shortly prior to January 20, 1965. On the morning of January 21, 1965, McLean's attorney went to the office of Waterman's general counsel to review and discuss a draft of a proposed purchase agreement which had been prepared by Waterman's general counsel. While McLean's attorney was reviewing the draft of the purchase agreement, Waterman's general counsel was reviewing the trust agreement which was to be executed as a method of divesting

McLean of control of Trucking. At 12 noon on January 21, 1955, the board of directors of Pan-Atlantic met and declared dividends on both its preferred and common stock to its stockholders of record on January 20, 1955, in the form of a promissory note in the total amount of $2,799,820.00 payable on or before February 20, 1955, and bearing interest of 4 percent. The minutes of the meeting at which this dividend was declared state in part as follows:

He [Waterman's president] recommended to the Directors that such dividend be declared, but, inasmuch as the corporation does not have available at this time sufficient cash to pay this dividend and also a dividend which he is proposing to recommend on the Common stock, he recommended, further, that this dividend be declared and be paid by and in the form of a promissory note of Pan-Atlantic Steamship Corporation, to be executed and delivered forthwith upon declaration of the dividend to Waterman Steamship Corporation, its sole stockholder, payable on or before February 20, 1955, bearing interest at the rate of 4% per annum.

The Chairman said that, inasmuch as there remains sufficient surplus net assets for such purpose after declaration of the dividend as above provided on the Preferred stock, he would recommend the declaration of a dividend on the Common stock in the amount of $2,689,374.00, to be paid by and in the form of a promissory note of Pan-Atlantic Steamship Corporation, to be executed and delivered, forthwith upon declaration of the dividend, to Waterman Steamship Corporation,

its sole stockholder, payable on or before February 20, 1955, with interest at 4% per annum.

He recommended that the dividend on the Preferred stock and the dividend on the Common stock, if declared, be declared payable and deliverable in the form of one promissory note, as above outlined, to stockholders of record as at the close of business on January 20, 1955.

The dividends were paid by execution and delivery of the promissory note. At 12:30 p.m. a special meeting of the board of directors of Securities to authorize the purchase and financing thereof of all the stock of Pan-Atlantic and Gulf Florida was held. At 1 p.m., the board of directors of Waterman met to authorize the sale of the stock of Pan-Atlantic and Gulf Florida to Securities.

Immediately following the meeting of the board of directors of Waterman the closing agreement dated January 21, 1955, between Securities and Waterman covering the purchase by Securities of all of the stock of Pan-Atlantic and of Gulf Florida was executed and delivered. This agreement provided in part as follows:

Without limitation as to any other agreement to guarantee or indemnify Waterman against loss in this instrument contained, McLean guarantees prompt payment and discharge of the respective liabilities and obligations of Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc., to all persons whomsoever as reflected by the books of Pan-Atlantic

Steamship Corporation and Gulf Florida Terminal Company, Inc., on the date of this instrument, including but without limitation, payment of any note or notes given by either corporation as a dividend, declared prior to the date hereof.

Securities' check for $700,180 was delivered to Waterman and Waterman delivered to Securities certificates for all of the stock of Pan-Atlantic and Gulf Florida. The trust agreement with respect to the stock of McLean and his brother and sister in Trucking was executed prior to the execution of the closing agreement. Also, on January 21, 1955, sometime prior to the execution of the closing agreement with respect to the purchase and sale of the Pan-Atlantic and Gulf Florida stock, McLean and his brother and sister resigned as officers and directors of Trucking and its subsidiaries.

At 1:30 p.m. on January 21, 1955, a special meeting of the new board of directors of Pan-Atlantic was held, presided over by McLean. At this meeting the board authorized the corporation to borrow $2,500,000 from McLean and deliver a note to him, and to borrow $299,820 from Securities, and to issue a check to Waterman for $2,799,820 in payment of the note Pan-Atlantic had issued to Waterman as a dividend.

McLean borrowed the $2,500,000 which he lent to Pan-Atlantic from Bethlehem Steel Corp., the loan being made to him immediately following the purchase of the Pan-Atlantic and Gulf Florida stock by Securities. Negotiations for this loan had been in progress for sometime prior to January 21, 1955.

On January 21, 1955, prior to the declaration and payment of amounts totaling $2,799,820 as dividends, Pan-Atlantic had earnings and profits of a least $2,799,820. Waterman's basis in the stock of Pan-Atlantic was $576,180, and its basis in the stock of Gulf Florida was $124,000. The adjusted basis for tax purposes of the total assets less total liabilities of Pan-Atlantic at December 31, 1954, was $3,913,346 and the adjusted basis for tax purposes of the total assets less total liabilities of Gulf Florida as of December 31, 1954, was $279,199.

Sometime during the period from January 21, 1955, through May 5, 1955, C. Lee Co., Inc., became a wholly owned subsidiary of Securities. On May 5, 1955, C. Lee Co., Inc., purchased substantially all of the stock of Waterman for cash.

On July 6, 1955, McLean transferred Pan-Atlantic's note of $2,500,000 to Securities in exchange for 50,000 shares of preferred stock in Securities. The reason for this transfer was that there was a public underwriting of stock of Securities taking place and the underwriters insisted that the $2,500,000 indebtedness not be owed by Securities' subsidiary, Pan-Atlantic, to an individual.

On October 31, 1955, Securities sold the notes of Pan-Atlantic in the principal sum of $2,500,000 and $299,820 to Waterman for cash.

About 3 years later on July 21, 1958, Waterman declared a dividend in kind to Securities of the $2,500,000

note. Subsequently, Securities contributed the $2,500,000 to Pan-Atlantic as paid-in capital by marking the note as paid.

Later in the year 1958 Pan-Atlantic paid the sum of $299,820 to Waterman in settlement of its note in that amount.

Petitioner on its consolidated income tax return eliminated from income the $2,799,820 declared dividend from Pan-Atlantic to Waterman and reported as the sales price of the stock of Pan-Atlantic and Gulf Florida the amount of $700,180.

Respondent in his notice of deficiency increased petitioner's reported income by capital gain of $2,799,533.80 with the following explanation:

It is determined that you realized a long-term capital gain in the amount of $2,799,533.80, as computed below, resulting from the sale of stock in Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc. which you failed to report on your return. Accordingly, taxable income is increased by $2,799,533.80.

OPINION

Petitioner takes the position that Waterman was the equitable as well as legal owner of the stock of Pan-Atlantic when the dividend of $2,799,820 was declared, that the issuance of Pan-Atlantic's note for $2,799,820 to Waterman was payment of the dividend "in proper-

ty" while Waterman was the legal and equitable owner of the Pan-Atlantic stock[1] and that because the dividend was declared and paid while Waterman was the legal and equitable owner of the Pan-Atlantic stock the $2,799,820 constituted a dividend paid by Pan-Atlantic to Waterman. Petitioner relies on the provision of respondent's Income Tax Regulations (sec. 1.61-9(c))[2] that:

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[1]Petitioner calls attention to the fact that this Court has recognized that a dividend be paid by a note citing *T. R. Miller Mill Co.*, 37 B.T.A. 43 (1939), affd. 102 F. 2d 599 (C.A. 5, 1939). Since respondent does not contend that as a matter of law a note may not be issued in payment of a dividend we do not consider such an issue to be involved in this case.

[2]Sec. 1.61-9(c), Income Tax Regs.

(c) *Dividends on stock sold.* When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller. When stock is sold between the time of declaration and the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend ordinarily is income to him. The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax. Nor can the purchaser deduct the added amount he advanced to the seller in anticipation of the dividend. That added amount is merely part of the purchase price of the stock. In some cases, however, the purchaser may be considered to be the recipient of the dividend even though he has not received the legal title to the stock itself and does not himself receive the dividend. For example, if the seller retains the legal title to the stock as trustee solely for the purpose of securing the payment of the purchase price, with the understanding that he is to apply the dividends received from time to time in reduction of the purchase price, the dividends are considered to be income to the purchaser.

When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller. • • •

Petitioner also relies on cases such as *Joseph L. O'Brien Co.*, 35 T.C. 750 (1961), affd. 301 F.2d 813 (C.A. 3, 1962), and *Sam E. Wilson, Jr.*, 27 T.C. 976 (1957), affirmed per curiam 255 F. 2d 702 (C.A. 5, 1958), which hold that a dividend declared and paid after the stockowner-taxpayer has contracted to sell such stock subject to contingencies stated in the contract is the income of the seller where the dividend is paid prior to the happening of the contingencies. These cases recognize that a "dividend" has been paid and is income either to the seller or purchaser. The problem resolved in these cases is whether the beneficial ownership of the stock had passed from the seller to the purchaser when the dividend was paid.

Respondent does not argue that the transaction whereby Waterman sold its stock in Pan-Atlantic to Securities was in form one whereby either the legal or equitable ownership of the stock passed from Waterman to Securities prior to the meeting of the board of directors of Pan-Atlantic at 12 noon on January 21, 1955, at which the dividend was declared or prior to the execution by the officers of Pan-Atlantic of the promissory note and delivery of the note to Waterman. It is respondent's position that irrespective of the form of the transaction whereby Waterman sold the stock of Pan-Atlantic to Securities, the substance of the transaction was a payment by Securities to Waterman

of $3,500,000 for the Pan-Atlantic stock. The import of respondent's argument is that in substance no dividend was declared or paid by Waterman. Respondent argues that the action of the bonrd of directors of Pan-Atlantic at its meeting held at 12 noon on January 21, 1955, in declaring a dividend and the action of the officers of Pan-Atlantic in executing and delivering a note to Waterman in payment of the dividend were mere subterfuge. Respondent takes the position that the entire procedure of the declaration and payment of a dividend by Pan-Atlantic to Waterman was a device designed to give the appearance of a dividend to a part of the purchase price of the Pan-Atlantic stock and that no purpose was served by causing a part of the purchase price of the stock to be labeled a "dividend" except the avoidance of income tax by Waterman. To support his position respondent points out that McLean had offered Waterman $3,500,000 for the Pan-Atlantic and Gulf Florida stock, that Waterman wanted to realize $3,500,000 if it disposed of the stock of these two subsidiaries, that Waterman did in fact realize $3,500,000 when it disposed of this stock of the two companies, that Pan-Atlantic did not have available cash to pay the dividend and that the entire $3,500,000 came by way of moneys procured by the purchaser to be paid over to Waterman. Respondent also stresses the fact that in the sales agreement between Waterman and Securities, the latter guaranteed prompt payment of the dividend note.

From the facts we have set forth in our findings, we conclude that Waterman in making its counter offer to McLean did plan the proposed sale in a way intended

to result in Waterman receiving $3,500,000 with funds obtained by McLean or his nominee (Securities) with approximately $2,800,000 of the amount designated as a dividend and with none of the assets owned by Pan-Atlantic or Gulf Florida being removed from those companies prior to the sale of the stock. It is also apparent that it was understood between the parties to the sale of the Pan-Atlantic stock that the purchaser would arrange promptly after the sale of the stock to supply Pan-Atlantic by loan or otherwise with the funds to pay the dividend note. Petitioner does not deny that the terms of Waterman's offer to McLean were carefully drawn with the intent of accomplishing a receipt by Waterman of cash of $3,500,000 from disposition of all its interest in Pan-Atlantic and Gulf Florida with approximately $2,800,000 of the amount received being an intercompany dividend which would be eliminated from taxable income because of the filing by Waterman and its subsidiaries of a consolidated Federal income tax return. Petitioner points out that except for the fact that Pan-Atlantic and Gulf Florida each had an ICC certificate which could not be directly transferred without approval by the ICC, Pan-Atlantic could have declared a dividend in kind to Waterman and thereafter Waterman could have sold these assets to Securities, or Pan-Atlantic could have directly sold its assets to Securities, or Pan-Atlantic could have merged with Waterman and the assets which had previously belonged to Pan-Atlantic could have been sold to Securities. Petitioner states that since Pan-Atlantic's basis in its assets exceeded $3,500,000, no taxable income would have resulted from a sale of the Pan-Atlantic assets to Securities under any one of these

arrangements. However, McLean was interested in having Securities acquire either the stock or assets of Pan-Atlantic and Gulf Florida only if the acquisition could be accomplished without the necessity of obtaining ICC approval. A fair inference from the record is that Waterman was interested in selling the stock or assets of Pan-Atlantic and Gulf Florida only if the sale could be made without the necessity of obtaining ICC approval. Both parties to the sale were aware of the fact that the obtaining of ICC approval of a sale of the assets or stock of Pan-Atlantic and Gulf Florida might require several years and thus delay consummation of the sale for that period of time. The offer made by Waterman to McLean was intended to result in Waterman's receiving in cash an amount it considered to be the approximate value of the assets of Pan-Atlantic and Gulf Florida without realizing taxable income from the transaction while carrying out the transaction in a manner which would not require ICC approval. Since the transaction was planned to accomplish these purposes, the parties were careful that no firm contract for the sale of the Pan-Atlantic and Gulf Florida stock to Securities was entered into until after Pan-Atlantic had declared a dividend and paid the dividend to Waterman by delivery of its promissory note to Waterman. Therefore, even though officers of Waterman were kept advised by McLean as to the progress being made in working out the details necessary to enable Securities to accept the offer of Waterman before February 1, 1955, there was no actual acceptance of the offer or legally binding contract of sale of the stock until after the dividend was declared and the note delivered. No official action approving

the sale was taken by the board of directors of either of the corporations which were the parties to the sale (Waterman and Securities) until after the dividend was declared and the note delivered. From the record we conclude that the transaction was deliberately and advisedly planned and executed in this manner. We do not, however, agree with respondent that it follows from the fact that the transaction was planned and carried out in such a form as to result in the realization by Waterman of no taxable income, that the substance of the transaction differs from its form. The substance here certainly was not a passing of the equitable interest in the stock to Securities followed by the declaration of a dividend resulting in Securities receiving a dividend. Securities borrowed the money to pay off the Waterman note from its major stockholder, McLean. Securities took neither cash nor assets out of Pan-Atlantic but the stock of that company represented Securities' entire interest in the company.

Securities did pay to Waterman for the Pan-Atlantic and Gulf Florida stock and in discharge of the notes given by Pan-Atlantic to Waterman as a dividend a total amount of $3,500,000. This was the same amount that McLean had offered to pay to Waterman for the Pan-Atlantic and Gulf Florida stock. However, Waterman had declined McLean's offer as made. Waterman refused to sell the Pan-Atlantic and Gulf Florida stock for $3,500,000 cash. The crux of the problem here is whether the planned form of the transaction here had sufficient substance so that it should be recognized for tax purposes. Both parties accept the principle that a taxpayer can conduct his affairs in such a manner

as to minimize his tax liability if there is substance to the transaction. The parties cite and discuss a number of cases involving sales of stock where the issue was whether some amount received by the seller out of the corporate assets, either by the corporation assigning such asset to the seller or declaring a dividend to the seller prior to the closing of the sale, was a part of the purchase price of the stock. Most of these cases turn on the precise provisions of the agreement of the parties. See *John R. West*, 37 T.C. 684 (1962).

Both parties discuss and distinguish from the instant case, the case of *Steel Improvement & Forge Co.*, 36 T.C. 285 (1961), revd. 314 F.2d 96 (C.A. 6, 1963). Respondent states that the facts of the instant case show even more strongly than did the facts in the *Steel Improvement & Forge Co.* case that in substance the transaction between the seller and purchaser was that the amount designated as a dividend was in fact a part of the purchase price of the stock. From this statement respondent concludes that the opinion of the United States Court of Appeals for the Sixth Circuit reversing our decision supports his position in the instant case but that our holding in *Steel Improvement & Forge Co., supra*, is not in conflict with his position.

Petitioner argues that our conclusion in *Steel Improvement & Forge Co., supra*, is a proper interpretation of the law but that the holding of the Sixth Circuit is not in conflict with the petitioner's position herein since the Sixth Circuit concluded that in substance the equitable ownership of the stock which was being sold by the taxpayer involved in that case had, pursuant

to a written contract of sale, passed to the purchaser of the stock before the declaration of the dividend and for that reason the Sixth Circuit considered that the dividend was a part of the purchase price of the stock. Petitioner states that since there was no firm contract for the sale by Waterman of the Pan-Atlantic stock to Securities either written or oral prior to the declaration of the dividend, the *Steel Improvement & Forge Co.* case is distinguishable from the instant case.

In *Steel Improvement & Forge Co., supra*, the taxpayer was negotiating with a Canadian company for the sale to the Canadian company of its stock in a Canadian subsidiary. During the negotiations it developed that the taxpayer wanted to realize $900,000 from the sale of the stock and the prospective purchaser was willing to have the taxpayer realize this amount from the sale but was unwilling to purchase the stock for this price because of the undistributed income which the corporation had accumulated which would affect the nature under Canadian law of the future distribution by the corporation to the purchaser. The parties, therefore, agreed that the corporation would declare a dividend of its surplus to the seller prior to the closing of the sale in the amount of its undistributed surplus. It was specifically agreed that an amount up to $180,000 could be declared as a dividend but if no dividend were declared the purchase price of the stock would be increased by only $64,000. The corporation did not have the cash to pay a dividend and it was agreed that the prospective purchaser would arrange for a loan to the corporation. After the offer of the seller outlining these terms had been accepted

by the prospective purchaser and the prospective purchaser had arranged for a loan to the corporation so that the dividend might be paid in cash, a dividend of $116,000 was declared and paid and the following day the sale of the stock was closed and the certificates delivered. The taxpayer in that case contended that in substance the purchaser was the beneficial owner of the stock when the dividend was declared and paid and therefore in substance the dividend was a part of the purchase price of the stock. Respondent contended that the agreement of the parties was that a dividend be paid to the taxpayer and that the substance as well as the form of the transaction was a payment of a dividend to the taxpayer. We held for respondent stating that the payment of the dividend to the seller was an integral part of the agreement with respect to the sale of the stock. We pointed out that the purchase price of the stock would not have been increased by the $116,000 if the dividend had not been paid and that the dividend was declared and paid prior to the closing of the sale and the transfer of the stock. The Sixth Circuit, in *Steel Improvement & Forge Co.* v. *Commissioner*, 314 F.2d 96, 97-98 (C.A. 6, 1963), reversing our opinion (36 T.C. 265), stated:

It is petitioner's contention that even though the payment was in the form of a dividend, it is necessary to look behind the surface of the transaction to determine its true character, and that such examination discloses that in substance the payment was actually a part of the purchase price. In support of this position, petitioner cites five cases which it claims are here controlling. It is true that a sum paid in the form

of dividends resulting in purchase price reductions by varying formulae was in each of these cases held not taxable as ordinary income, but subsequent to sale the stock was retained as security for the balance of the purchase price by the seller. Here, however, the petitioner retained full control and ownership of the subsidiary and caused distribution to be made to itself, and simply excluded the amount of the dividend from the purchase price. On the basis of this distinction the Tax Court, after a detailed review of these cases found them to be without application, but we find ourselves unable to share that view. Rather, we incline to the position taken by the dissenting member of the Tax Court and conclude that the disputed dividend is properly taxable as ordinary income to the party having beneficial ownership of the stock at the time when the dividend is established, it being that party who bears the operating risks of the business and stands to benefit from profits or suffer detriment from losses.

This conclusion seems particularly appropriate under the facts of the present case, wherein it clearly appears from the record of the negotiations that the parties considered the $116,000 at issue to be part of the purchase price. In those negotiations petitioners said it must realize $900,000, purchaser made a direct payment to petitioner of $634,000 and, in effect, made arrangements for payment of a balance by checks for $150,000 and for $116,000. The fact that the latter was in the technical form of a dividend does not alter the fact that it constituted a portion of the $900,000 purchase price arrived at by negotiation. Thus, looking behind the technical form to determine the substance,

we conclude that like the rest of the $784,000, the $116,000 was a part of the purchase price demanded and received by the petitioner, and is accordingly taxable as a capital gain rather than as ordinary income.

Respondent contends that in the instant case as in *Steel Improvement & Forge Co.* v. *Commissioner, supra*, the seller wanted to obtain a fixed amount for its stock, the purchaser was willing to pay that amount for the stock and the designation of a portion of the agreed price as a "dividend" did not in substance change the nature of the payment from a part of the purchase price of the stock to a dividend. From this analysis respondent concludes that it follows from the holding of the Sixth Circuit in *Steel Improvement & Forge Co.* v. *Commissioner, supra*, that his position in the instant case is correct.

Petitioner contends that the primary basis of the Sixth Circuit's holding in *Steel Improvement & Forge Co.* v. *Commissioner, supra*, was that the beneficial interest in the stock had passed to the purchaser under a written sales contract when the dividend was declared and that there was no similar contract in the instant case. Petitioner states that in the instant case the facts show that neither Securities nor McLean had formally accepted Waterman's offer prior to the declaration of the dividend. While there was a general understanding between the parties as of the morning of January 21, 1955, that all parties were prepared to conclude the transaction, petitioner argues that the absence of a firm agreement by the parties to the definite terms of the sale prior to the declaration and payment

of the dividend distinguishes this case from *Steel Improvement & Forge Co.* It is petitioner's position that a general understanding that a sale will ensue does not cause the purchaser to have the "beneficial ownership" of the stock at the time the dividend is declared or to be the party "who bears the operating risks of the business and stands to benefit from profits or suffer detriment from losses." If petitioner in this argument is distinguishing between a dividend declared and paid to the seller after execution of a written agreement for sale of stock and a dividend declared and paid prior to execution of a written agreement for sale of stock but after a general understanding as to the sale of the stock (not finally reduced to writing), has been arrived at between the purchaser and seller, the distinction is a shadowy one. However, we recognize that there are numerous cases which have turned on similar shadowy distinctions in the area of who is the recipient of corporate dividends or distributions in kind or who is the equitable owner of corporate stock.

Petitioner states that in a transaction of the type here involved, the parties have the right to cast the transaction in terms most beneficial to them. We agree with petitioner that in negotiating for sales of corporate stock, declarations of corporate dividends or sales of corporate assets, the parties may properly so arrange the form of the transactions as to reduce or eliminate the taxable income resulting therefrom. Where the transaction is carried out in a recognized form to accomplish its purpose and is not a sham or subterfuge, its substance should not be considered to differ from its form merely because the same result might have

been accomplished by the parties by another method which would have produced a higher tax.

In *United States* v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451, 454-455 (1950), the Court stated in this regard:

> This language does not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution.[a] While the distinction between sales by a corporation as compared with distribution in kind followed by shareholder sales may be particularly shadowy and artificial when the corporation is closely held, Congress has chosen to recognize such a distinction for tax purposes * * *
>
> Here, * * * the Court of Claims has found that the sale in question was made by the stockholders rather than the corporation. The Government's argument that the shareholders acted as a mere "conduit" for a sale by respondent corporation must fall before this finding. The

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[a]What we said in the Court holding Co. case was an approval of the action of the Tax Court in looking beyond the papers executed by the corporation and shareholders in order to determine whether the sale there had actually been made by the corporation. We were but emphasizing the established principle that in resolving such questions as who made a sale, fact finding tribunals in tax cases can consider motives, intent, and conduct in addition to what appears in written instruments used by parties to control rights as among themselves. See, *e.g.*, *Helvering v. Clifford*, 309 U.S. 331, 335 - 337; *Commissioner v. Tower*, 327 U.S. 280.

subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.

The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern. * * *

Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate. It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. Here as in the Court Holding Co. case we accept the ultimate findings of fact of the trial tribunal. Accordingly the judgment of the Court of Claims is *affirmed*.

In the instant case because Waterman and Pan-Atlantic had filed consolidated returns, Waterman was permitted by respondent's regulations to eliminate from income dividends paid to it by Pan-Atlantic. Since this treatment of the intercompany dividend was permitted, Waterman was entitled to arrange its affairs so as to obtain the resultant tax advantage. This is

what was done. Pan-Atlantic declared a dividend to Waterman prior to the sale by Waterman of the Pan-Atlantic stock to Securities.

Unless a taxpayer who is contemplating a sale of stock may not for reasons influenced by the tax consequences of the sale refuse to sell that stock until after the accumulated earnings of the corporation have been declared as a dividend without having the declaration of the dividend disregarded for Federal tax purposes, Pan-Atlantic did in substance declare a dividend to Waterman. Generally, where a sale of stock is under consideration, the price a seller is willing to take or a purchaser is willing to pay prior to removal from the corporation of some or all of its accumulated earnings by payment of a dividend, will be greater by approximately the amount of the dividend than the price after a dividend has been declared and paid to the seller. Where the parties to the sale are in agreement as to whether a dividend is to be paid to the seller and the equitable interest in the stock as well as legal title thereto remain in the seller until after the dividend is declared and paid, the dividend is that of the seller. We do not consider that the mere fact that the corporation finds it necessary to pay the dividend by a note and to borrow the money to pay that note or the fact that the prospective purchaser arranges the loan causes the substance of the transaction to change. We therefore conclude that Waterman did receive a dividend of $2,799,820 from Pan-Atlantic prior to its sale of the Pan-Atlantic stock.

Because of other adjustments to petitioner's taxable income which are not in issue here,

Decision will be entered under Rule 50.

Reviewed by the Court.

TANNENWALD, *J.*, dissenting. I think the majority fails to recognize the basic issue involved in this case. We are not called upon to decide to whom a conceded dividend should be taxable as such but rather whether there was any dividend at all.

Concededly, the distinctions drawn in determining the tax effects of corporate distributions are "shadowy." See *Waltham Netoco Theatres, Inc.*, 49 T.C. 399, 404 (1968), on appeal (C.A. 1, Apr. 24, 1968). But this difficult fact does not require us to blind ourselves to the realities of a situation and exalt form over substance.

The plain unadulterated fact is that no dividend was declared or paid by Pan-Atlantic to Waterman or anyone else. The note issued by Pan-Atlantic was merely a piece of paper, which served only a temporary purpose and disappeared. Cf. *Gregory v. Helvering*, 293 U.S. 465 (1935). The funds with which ultimate payment was made by Pan-Atlantic were supplied by McLean and were not received by Waterman until after the sale was completed. McLean offered to pay $3,500,000 as the purchase price and that is precisely the amount it finally paid. When the transaction was completed, Pan-Atlantic was no richer and no poorer than it had

been at the start. Only a portion of its accumulated earnings and profits had been converted into capital.

In *Steel Improvement & Forge Co.* v. *Commissioner*, 314 F. 2d 96 (C.A. 6, 1963), reversing 36 T.C. 265 (1961), both this Court and the Court of Appeals dealt with the issue involved upon the assumption that a dividend had been paid and that it was necessary to decide to whom the dividend was taxable. The case is therefore inapposite. Moreover, I note a distinguishing fact that in *Steel Improvement & Forge Co.*, the dividend was actually paid in cash before the sale was closed.

RAUM, DAWSON, and SIMPSON, JJ, agree with this dissenting opinion.

APPENDIX D

Senate Report No. 960, 70th Cong., 1st Sess., 13-15 (1927), (1939-1 Cum. Bull. (Part 2) 409, 417-419):

* * * *

"The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have realized no gain. The failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. It would be just as unreasonable to demand that an individual engaged in two or more businesses treat each business separately for tax purposes.

* * * *

"... While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government."

• • • •

Internal Revenue Code of 1954 (26 U.S.C. 1964 Ed.):

SEC. 243. DIVIDENDS RECEIVED BY CORPORATIONS.

(a) General Rule. — In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

(1) 85 percent, in the case of dividends other than dividends described in paragraph (2) or (3);

(2) 100 percent, in the case of dividends received by a small business investment company operating under the Small Business Investment Act of 1958; and

(3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1)).

* * * *

SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

* * * *

(c) Exclusion of Certain Dividends. —

(1) In general. — No deduction shall be allowed under section 243, 244, or 245, in respect of any dividend on any share of stock —

(A) which is sold or otherwise disposed of in any case in which the taxpayer has held such share for 15 days or less, or

(B) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make corresponding payments with respect to substantially identical stock or securities.

* * * *

SEC. 312. EFFECT ON EARNINGS AND PROFITS

(a) General Rule. — Except as otherwise provided in this section, on the distribution of

property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of —

(1) the amount of money,

(2) the principal amount of the obligations of such corporation, and

(3) the adjusted basis of the other property,

so distributed.

* * * *

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.* — For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders —

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

* * * *

SEC. 317. OTHER DEFINITIONS.

(a) Property. — For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

* * * *

SEC. 1501. PRIVILEGE TO FILE CONSOLIDATED RETURNS.

An affiliated group of corporations shall, subject to the provisions of thig chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated

return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

SEC. 1502. REGULATIONS.

The Secretary or his delegate shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

Treasury Regulations on Income Tax (26 C.F.R.):

SEC. 1.301-1. RULES APPLICABLE WITH RESPECT TO DISTRIBUTIONS OF MONEY & OTHER PROPERTY.

* * * *

(d) Distributions of Property to Corporate Shareholders. — .... If the property distributed consists of the obligations of the distributing corporation, or stock of the distributing corporation treated as property under section 305(b), or rights to acquire such stock treated as property under section 305(b), the amount of such distribution shall be an amount equal to the fair market value of such obligations, stock, or rights....

* * * *

(h) *Basis.* — The basis of property received in the distribution to which section 301 applies shall be —

(1) If the shareholder is not a corporation, the fair market value of such property;

(2) If the shareholder is a corporation —

(i) In the case of a distribution of the obligations of the distributing corporation or of the stock of such corporation or rights to acquire such stock (if such stock or

rights are treated as property under section 305(b), the fair market value of such obligations, stock, or rights;

* * * *

SEC. 1.1502-31A. BASES OF TAX COMPUTATION.

* * * *

(b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:

(1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

(ii) No net operating loss deduction shall be taken into account;

(iii) No capital gains or losses shall be taken into account;

* * * *

(2) *Other computations on separate basis.* The various other computations required by the regulations under section 1502 to be made by the several affiliated corporations shall be made in the case of each such corporation in the same manner and under the same conditions as if a separate return were to be filed, but with the following exceptions:

(i) *Taxable income.* The taxable income used in any such computation shall be the taxable income of the corporation determined in accordance with the provisions of this section.

(ii) *Dividends received.* In the computation of the dividends received, there shall be excluded all dividends received from other members of the affiliated group.

(iii) *Capital gains and losses.* Capital gains and losses, short-term capital gains and losses, long-term capital gains and losses, and the additional capital loss deduction authorized by section 832(c) (5) shall be determined without regard to:

(a) Gains or losses arising in intercompany transactions (other than gains described in section 357(c)) and gains recognized to the distributing corporation pursuant to section 311 (c) by reason of distributions by one member of the group to another member of the group,

• • • •

SEC. 1.1502-36A. LIMITATION ON ALLOWABLE LOSSES ON SALE OF STOCK, OR BONDS, OR OTHER OBLIGATIONS

(a) *General rule.* No loss shall be allowed under §§ 1.1502-33A, 1.1502-34A, or 1.1502-35A upon the sale or other disposition of stock or bonds or obligations to the extent that such loss is attributable to —

(1) Transfers of assets within the affiliated group (by sale, gift, or otherwise) without consideration or at markedly fictitious values, during the period in which the corporations were affiliated (whether or not a consolidated return was made), or

(2) A distribution during a period in which the corporations were affiliated of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group.

(b) *Qualification of general rule.* Paragraph (a) of this section shall not be considered as in any way limiting the operation of the provisions of subtitle A of the Code relating to the basis for determining gain or loss upon the sale or other disposition of property, but as being in amplification of and not in substitution for such provisions; subject, however, to this qualification: that to the extent that the transfers of assets referred to in paragraph (a) of this section are taken into account under the terms of subtitle A in making adjustments in the basis, such transfers will not be taken into account, in denying losses under paragraph (a) of this section. As added T.D. 6894, September 8, 1966, 31 F.R. 11835.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term 1969

No. 27,563

T.C. Docket No. 6500-66

WATERMAN STEAMSHIP CORPORATION,
Petitioner-Appellee,
versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Appeal from the Decision of the Tax Court of the United States (Alabama Case)

Before WISDOM, SIMPSON and CLARK,
Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the decision of

the said Tax Court in this cause be, and the same is hereby reversed with directions to enter final judgment for the Commissioner.

It is further ordered that petitioner-appellee pay to respondent-appellant, the cost on appeal to be taxed by the Clerk of this Court.

July 15, 1970

Issued as MANDATE:

CERTIFICATE OF SERVICE

I, Wm. H. Armbrecht, counsel for Petitioner herein, hereby certify that on the ____ day of December, 1970, I served four copies of the within Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit on the Respondent herein, the United States of America, by mailing the same postage prepaid to The Solicitor General, Department of Justice, Washington, D.C. 20530.

Wm. H. Armbrecht